

## Commentary on "Enhancing Competitiveness: National Economic Policies"

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Beauty, it is said, lies in the eyes of the beholder and the account of the Reagan administration economic policies provided by Dr. Johnson confirms this adage. Viewing through the prism of Rosy-Scenario colored spectacles, Dr. Johnson pronounces Reaganomics a success. The American economy is finally on the right track. The modified Keynesianism governing U.S. economic policy in the postwar period has been abandoned. Inflation has been controlled, investment has been stimulated, and individual initiative unleashed by tax rate reductions. Developments such as the high real interest rates, the strong dollar, the large trade deficits, and the large net capital inflows into the United States should not be seen as problems for the aggregate economy, but rather as indicative of the policy's success and likely to be with us for some time. Thus, the long-run solution to the problems that a strong dollar, high real interest rates, and low real commodity prices pose for American agriculture lies not in expanding government programs to offset these developments, but in adjusting to them through market processes.

Dr. Johnson sees no reason for drastic alterations in economic policy settings. The economy is on a track that will produce growth rates between 3 and 4 percent in the foreseeable future. He concedes that the program did not work as smoothly as originally planned, because the delays in phasing in the tax cuts and the excessive restraint by the Federal Reserve induced a recession. But he argues that the ensuing expansion provides evidence of the policy's success.

The unusually strong role played by investment in the recent expansion is the key to Dr. Johnson's analysis. Higher after-tax rates of return on investment and increased confidence in the U.S. economy have en-

couraged Americans and foreigners to engage in an unusually large amount of capital formation. The shift in the U.S. position from international creditor to international debtor does not concern Dr. Johnson since the borrowing is being used to build the capital stock necessary to service the debt in the future.

My own interpretation differs from that of Dr. Johnson in several respects. In Kansas City, of all places, we know it is dangerous to predict the World Series at the end of the fourth game—to do so would be a Cardinal error. Similarly, I see the outcome of current policies as a lot less rosy and a lot more blue.

I do agree that, in its first few years, the Reagan program achieved some important gains. Given the Federal Reserve's decision to fight inflation with tight monetary policy, it was appropriate to provide a fiscal stimulus to bring the economy out of the 1982 recession. Failing to raise revenues and to reduce spending to bring the budget into balance as the economy moved back to full employment, however, was a mistake. The buy-now, pay-later fiscal policies adopted at the behest of this administration should not be judged purely on their recent impacts. The current stance of macroeconomic policy is dangerously unbalanced, with agricultural and other price-sensitive traded goods sectors of the economy subjected to unwarranted pressures. If a stronger exchange rate resulted primarily from foreign capital inflows to fund real capital formation, these pressures might constitute a necessary part of the adjustment process. But the foreign capital inflows have been absorbed primarily by the government sector to finance tax cuts that have gone mainly into consumption and defense spending. Unless we intend to launch a war of conquest, neither consumption nor defense will aid us in the future in servicing or repaying our debts.

Dr. Johnson and I disagree over whether this economy has experienced an investment boom or a savings bust. A deficit in the trade balance in goods and services indicates that the nation's spending exceeds its income; that is, it is borrowing. A change in national borrowing, in turn, reflects changes in net private borrowing and/or net government borrowing. Dr. Johnson argues that the dominant reason why this nation's spending exceeds its income lies in the strength of investment. He, therefore, puts most of the explanation for the current account deficit on net private borrowing.

In fact, the data do not support this interpretation. Between 1980 and 1984, net lending by the U.S. private sector changed very little as a share of GNI? In 1980, gross private savings (16.5 percent of GNP)

exceeded gross private investment (15.3 percent of GNP) by 1.2 percent of GNP? In 1984, gross private savings (18.4 percent of GNP) exceeded gross private investment (17.4 percent of GNP) by 1.0 percent of GNP. Thus, virtually none of the additional national borrowing was required net by the private sector. Indeed, before the advent of supply-side economics during the Carter administration, the United States invested similar shares of gross investment in GNP without borrowing from abroad. On the other hand, U.S. government increased its deficit by 2.19 percent of GNP, an amount fully reflected in the growth of the overall trade deficit as a share of GNP?

How strong has private investment been in the current recovery? Has it been of the appropriate magnitude and type to enable the nation to service its growing international obligations? Sorting out the evidence is a complex task. As a share of nominal GNP, the peak of 17.4 percent in 1984 for the Reagan years resembles that of the Carter peak of 17.9 percent in 1978 (and 17.5 percent in 1979). Between 1977 and 1980, the years under Carter, investment averaged 16.9 percent of GNP? This compares favorably with the 15.4 percent share constituted by investment between 1981 and 1984.

Measured in real terms, however, the recent investment does appear unusually strong. As a result of declines in construction costs (because of weak wage growth in that sector) and in equipment prices (because of the strong dollar and technological innovation) investors obtained about 1 percent more gross investment relative to real GNP than they did in 1979. But once depreciation is **accounted for**, even the real net national investment figures remain lower than in the Carter years. As a share of real net national product, real net investment in this recovery (1983:Q1-1985:Q2) of 6.2 percent remains below the 6.7 percent share recorded in the 1970s. Moreover, very little new investment has taken the form of increased purchases **of the** specialized machinery required to maintain the industrial base. According to my colleague Barry Bosworth, about 93 percent of the growth in equipment spending since 1979 occurred in either trucks or office equipment.<sup>1</sup> Thus, instead of increased capital formation in America's farms, mines, and factories, the investment is flowing into its offices—scarcely the appropriate preparation for servicing our international debt. Although Americans may be buying more than usual for their investment dollar, little evidence

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<sup>1</sup> Barry P. Bosworth, Taxes and the Investment Recovery: *Brookings Papers on Economic Activity*, 1:1985.

exists to confirm that they are allocating an unusually large share of their incomes to prepare for the future tax and interest payment.

To the degree that he sees a problem, Dr. Johnson points only to excessive government spending. He claims that government spending financed through borrowing has the same economic impact as government spending financed by taxes. Since bonds are financed by future taxes, all spending requires tax increases. I doubt this equivalence theorem is valid in practice. If it were, we should have seen an increase in private U.S. savings commensurate with the increase in the U.S. government budget deficit as private Americans make provisions for their future tax payments. They have not as yet made such provisions.

Over the long run, therefore, I believe that this nation will not have invested or saved enough to service its growing indebtedness. Americans in the future will have to tighten their belts, both by paying more taxes and by paying higher prices for imports. Assuming that foreigners remain confident enough to sustain their capital inflows, the interest payments eventually are going to accumulate. These interest rate outflows will in turn weaken the dollar, and by making U.S. imports more expensive, they will reduce our living standards. When our future living standards decline, the legacy of Reaganomics will look quite different. On the other hand, the U.S. agricultural and manufacturing sectors will have to provide the goods necessary to service and repay our current loans to foreigners. For that reason, I believe the medium-term prospects for the traded goods sector are much brighter than Dr. Johnson suggests. The real exchange rate will have to fall even further than it has increased to attract resources back into farming and manufacturing, not only to restore the trade balance to its original position, but also to service the decline in our international indebtedness.

Let me suggest, in closing, that this nation would be far better served for the future if an installment program that included both revenue increases and expenditure cuts were immediately enacted while there remained strength in the economy. Such a program would bring immediate benefits to the traded goods sectors of the economy and, over the long run, remove the burdens that the current stance of policy will leave to the future.