B186. "Kicking economy on way down" The Plain Dealer(OH), (July 26, 1988).

Under the guidance of mainstream economists, the country is locking into a highly dubious policy. Experts, public leaders and large segments of the public are forming a consensus that after the election the next president ought to cut domestic (budgetary) and international (trade) deficits drastically.

This is what a bipartisan National Commission on Economics is expected to recommend, a policy that has already been favored by 54 other study groups, public interest lobbies, etc., according to one list.

Specific plans for ‘89 economic policy vary, but a typical scenario calls for reducing deficit to zero by 1991. This would require at least a $70 billion reduction in public expenditure and a similarly hefty increase in taxes. The trouble is such that a policy is likely to cause a severe recession in 1989. The recovery is already very old. There are already signs of inflation and rising interest rates, a precursor of recessions. Sharply reducing demand in 1989 may hence kick the economy on its way down; at least it will make a recession much more likely and more severe.

Mainstream economists realize that such a recession would *increase* the domestic deficit. They nevertheless favor administering the painful therapy in 1989 for trade-imbalance and political reasons. They seek to avoid a looming calamity. The United States is still adding $10 billion or more each month to its overseas indebtedness as it finances the excess of import over export, by owing ever more dollars to foreigners. Signs abound that foreigners are less willing to take our dollars.

Given this background they may at any moment be spooked by some unexpected piece of bad news and withdraw a large part of their funds. This would sharply drive up interest rates in this country and send the American economy into a deep recession. Hence, in effect, economists call for a preventive recession to cut trade deficits before a panic sets in. Politically, they believe, the most opportune time for such a bitter medicine, is shortly after the elections.

Then what? We cannot stay in a recession forever to keep imports down. The idea is that the resources released by suppressed consumption will be used for exports and investment. It is here that the consensus scenario is faulty for several reasons.

First, the economies of other countries are likely to slow down, if not fall into a recession, once the United States suddenly reduces its imports - their exports! West Germany and Japan already have shown a great reluctance to stimulate their economies. Also, a major American recession may be the event that spooks foreign investors rather than prevents a run on the dollar. Most important, there is a major socioeconomic point that is quite well-known but whose relevance to the issue at hand has been largely ignored: namely, stickiness.

Stickiness refers to the fact that consumers, investors and business executives are slow to adjust their behaviors to signals included in changes in prices, public policies, etc. Thus, it took years for most people to open IRAs, even though IRAs are clearly in their interest and were widely advertised. It took years for the deficits that Lyndon Johnson created to finance the Vietnam War before the expected inflation took place. And it is taking much longer than many economists expected for the decline in the value of the dollar to have the expected effects.

Significant changes in the level of investments and of exports have a singularly slow pace. While consumption can be cut quickly in 1989 by gutting public expenditures and raising taxes, it will take years before exports will be expanded significantly, enough to offset the domestic loss in demand. It takes years for a corporation to learn to adapt its products to overseas markets, to modify its advertising, to develop local distribution networks, and so on. And investment plans - to expand capacity - will likely be curtailed in a recession, at best grow slowly. Also, executives learned to expect frequent changes in government policies, and hence do not rush to change their investment plans.

Anyway, it takes years to plan, build and equip a new plant. In short, many economists talk about the two policies as if they were dials one could readily reset: turn consumption down; investment and exports up. In effect, while one is like a dial, the other is more like rebuilding the whole machinery. The likely result of the considerable mismatch in the pace of the constricting and the constructive policies is hence a painful and costly recession, with little lasting cure on the export and investment fronts.

We need instead first to introduce a policy that encourages investment and reduces the deficits only slowly, as capacity to produce and to export expands. Such a policy might include new incentives for saving, for example, doubling the amounts one may deposit in one’s IRS and allowing individuals to contribute to a new IRA.

It would encourage investment by taxing speculation and by increasing the tax on short-term capital gains while lowering it on long-run ones. It would segregate Social Security from the budget and use its surplus for long-term investment in a portfolio of corporate and government bonds. Tax credit for investment might be reinstated.

Other policies can be devised once expanding capacity and increasing productivity become our main goal - not merely depressing domestic consumption. To buy time and credibility, to reassure the foreigners, we may follow Martin Feldstein’s idea of introducing an iron-clad, multiyear commitment to reduce the budgetary deficit. This would also help lower interest rates, which we need in order to reduce the costs of capital, of investment.

We need a constructive program of rebuilding and expanding capacity, one that will lead us to restore our ability to pay for our standard of living, defense, and a more just society.