

REAGANOMICS: TEN YEARS LATER

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(Resumen)

Diez años parece un lapso de tiempo suficiente para evaluar en perspectiva la política económica llevada a cabo en USA tras la llegada a la Casa Blanca del presidente Ronald Reagan. El presente artículo intenta matizar la quizás excesiva euforia con que a veces ha sido tratada, desde un punto de vista económico, la presidencia de Reagan, y aporta datos que pueden dar pie a considerar que lo que muchos han considerado una revolución económica exitosa bien pudiera considerarse un fracaso.

El fracaso se refiere a los colosales déficits fiscales y de balanza de pagos de los años de la presidencia de Reagan, así como a la incapacidad para hacer a la economía USA más competitiva, menos desigual y con una mayor capacidad de ahorro. En el aspecto positivo, evidentemente se reconoce el éxito de Reagan en la lucha contra la inflación y en la creación de empleo.

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The recovery phase of the last economic cycle of the American economy lasted since the first semester of 1983. Since then, many things have been said, and written, about what has been called the economic revolution of "Reaganomics".¹⁰ Reaganomics, indeed, represented a very serious attempt to change the course of U.S. economic policy. This article, now that the Reagan presidency has ended, evaluates the impact and the consequences of the economic policies followed in the country during the period 1981-1988.

Inflation and Growth

The basic macroeconomic data of the 80's in the United States appear in Table 1. In this table, we observe the great achievement in the battle against inflation (from 10.3% in 1981 to 3.2%, in only two years). The behavior of the rest of the variables doesn't seem to have been as spectacular as this, keeping in mind the costs (later to be referred to) which the policies incurred.²

Regarding the behavior of the inflation rate, and apart from the fact that its reduction was a consequence of the restrictive monetary policies executed earlier by the Federal Reserve in the late 70's, it must also be said that the behavior of the exchange rate of the dollar had a lot to do with it. In fact in the period from 1980 to 1985, the dollar appreciated in real terms by more than 40%, due to the persistence of large fiscal deficits and restrictive monetary policies.

The second relevant variable that appears in Table 1 is the rate of growth of the gross national product (GNP). As it can be clearly observed, the main point is that the United States was coming across one of the longest economic recoveries in its history. The Reagan Administration was characterized, in the first place, by an

important recession (the GNP, in 1982, dropped by 2.5%), followed later by an economic expansion that still lasted into the 90's.

The average growth rate of the United States GNP, in the economic expansion period from 1983 to 1988, was 3.7%. This figure is important, but maybe not as impressive, especially after the expectations generated in the country by the change in economic management.

There are several reasons why the economic growth wasn't as high as it was expected, and didn't surpass the results of other recent periods of economic expansion in the United States. One of them has to do with the low rate of productivity growth in the country; another, with the process of deindustrialization taking place in the United States in those years. It can be said that both reasons are interdependent, as the US is becoming more and more a country specialized in services whose rate of productivity growth is very low.

Savings and Investment

Two economic variables of special interest for the economic development of any country are savings and investment. Both are historically presented in Table 2 and show a behavior during the Reagan years that is worth analyzing. Regarding savings, data are very clear: concerning the individual savings rate, the United States citizens saved, in 1980, 7.1% of their disposable income and, in 1987, they only saved 3.8%. This decrease in family savings added to the "dissaving" of the public sector (that we will later analyze) made national savings, which includes savings of the private sector as well as those from the public sector, decrease from 16.2% of the GNP in 1980 to only 12.4% of the GNP in 1986.³ The OECD, in fact, designated in 1986 the United States as the country with the lowest national saving rate among the 24 countries that constitute the organization.

The theoretical basis in which supply side economists based themselves to expect an increase in private savings were not, in fact, corroborated. Private savings didn't increase as a result of higher interest rates and, on the other hand, the "dissaving" of the public sector, not being perceived by the private sector as larger taxes in the future, also prevented the private savings from rising.

Regarding investment, table 2 shows that gross investment in the U. S. during the eighties was a bit less than during the sixties and the seventies. However, when studying the behavior of net investment, we see that an important deterioration has taken place: during the fifties net investment as a percent of GNP was 7.0%; during the sixties the figure was 7.1% ; during the seventies, 6.7% and during the eighties the figure dropped to the level of 4.7%. What is the reason for this apparent contradiction between the near maintenance of gross investment and the drop of net investment? The answer is that, in the 80's, the depreciation of the existing stock of capital increased, probably because this became of shorter duration. The reason why the average useful life of investment goods decreased in the 80's in the US has to do probably with the high real interest rates of the country's recent history. Another interesting explanation of the shortening life of investment goods is the fact of the everyday larger property of American assets held by foreigners, with the outcome

that the US economy is becoming more oriented to short-term assets, in detriment to long-term assets.

Anyway, the fact of the United States being an open economy was crucial to permit, at least, the maintenance of gross investment. Had the United States been a closed economy, the drop in national savings, which we mentioned above, would have caused, beyond any doubt, an important drop in investment. But how was the maintenance of investment possible, despite the continuous fall in national savings?

The answer lies in the arrival of sufficient external savings that filled the existing gap between internal savings and investment. The problem was that the United States, which in 1980 lent to foreign countries, in net terms, a total of 13 billion dollars, received, only six years later, in 1986, 144 billion dollars from abroad. Some time during 1985, the United States became a net debtor country in the international financial sphere, and it fastly supplanted Brasil as the nation with the largest external debt on earth.

Employment and Income Distribution

Another important subject which has been largely discussed in the last few years, mainly due to its different evolution on either side of the Atlantic, is that of employment creation. The different behavior of the United States and Europe is based on the fact that the United States economy has been showing a high rate in the creation of employment, although accompanied by low productivity growth. Europe's problem, on the other hand, lies in its high unemployment rates.

In the period from 1973 to 1986, employment grew in the US to the order of 28%, compared with 11% growth in Japan and null growth in the EEC. Since 1970 more than 30 million jobs have been created in the United States, while in Europe the employment figure came to a standstill during the same period. Taking France, for example, and comparing it to the United States, the unemployment rates were, in 1970, 2.4% in France and 4.8% in the United States. By 1987, the unemployment rate had almost quadrupled in France rising to 10.5% while in the United States it was only 6.2%.

The services sector has absorbed, since 1970, 29 out of the 30 million jobs generated in the United States economy. In this sector of the US economy work today 70% of the employed population. And here lies one of the reasons to worry about the "quality" of the new jobs generated in the country. There are several data that make us think that such deterioration in the quality of jobs has taken place: in the first place, most of the jobs generated in the services sector have been of low qualification and low salary; in the second place, there seems to be an important growth, since 1970, of what some authors have called "unvoluntary employment at part-time jobs".

Another preoccupying aspect of the recent evolution of the United States economy, which evidently relates to the above, is the progressive reduction of industrial production in the country, with the resulting drop in the employed population in that sector. This subject is preoccupying because the expansion in the industrial sector determines, in some way, the total economic expansion of the

country, the amounts devoted to research and development, the rate of growth of productivity in the country, and the creation of qualified jobs and it generally determines the future of the economic development of the country.

Another subject to be discussed in this review of the economic performance of Reagan's presidential period is that related to income distribution. Different data on this issue show a deteriorating situation that probably began in the mid 70's and worsened during the eighties. During the Reagan presidency it seems to have been true the slogan used by Governor Dukakis in his electoral campaign, that the rich had become richer, the poor poorer and the middle class was squeezed in between.⁴

The Twin Deficits

What are the imbalances, and also the costs, that the Reagan economic policies generated in both the short and the long run? The most important are two: tremendous fiscal deficits, which increased the internal debt to levels never reached, and the not less important deficits in the balance of payments which have catapulted the US to the first place in the ranking of countries with foreign debt.

How was such a critical situation reached in the public finance of the country? The answer lies in the kind of economic policy carried out by Reagan after his arrival at the White House. Such policy had two main foundations: on the one hand a tax reduction, on the other, a public expenditure reduction.

Concerning taxes, Reagan's plan dealt with two aspects: the first was to reduce corporate taxation, the second to reduce personal taxation. Concerning public expenditure, Reagan's economic program promised practically the impossible, to reduce public expenditure, with an immediate tax reduction policy (a policy therefore potentially generating fiscal deficits) and with the expansive defense policy that began in 1982. Despite the drastic cut on the rest of the budget outlays, total expenditure darted to figures around 23-24% of the GNP and only in the last years of the Reagan presidency was a moderate decline possible.

Which are the consequences imposed by the continuous fiscal imbalances of the Reagan presidency? In the first place, and breaking away with a decreasing tendency coming from the Second World War, the ratio Public Debt/GNP has not stopped from growing. In 1980 it was 23.1%; in 1986, 37.2% and it reached 40% in the late 80's. In the second place, interest payments were the fastest item to grow (currently representing 3.2% of the GNP). In the third place, the fiscal deficit has been the cause of the high interest rates in the country, which brought about a massive arrival of foreign capital urging the appreciation of the dollar during the first half of the eighties. This leads us to the second great imbalance caused by Reagan's economic policies, the foreign imbalance, to which we now refer.

The balance of payments on current account in the United States turned out to be, on average during the fifties, positive, and of the order of 0.1% in relation to the GNP. During the sixties, the average annual balance was still positive and of the order of 0.5% of the GNP. During the seventies the average was 0.0%, which meant that, on average, the balance on current account was balanced in that difficult decade. Since 1981, however, there has been a drastic change in tendency by which

the annual average of the balance on current account has been, as a percentage of the GNP, -2.1%. The balance on current account, as well as the trade balance of the 80's, appears in table 1. We observe, there, how a surplus on current account of 400 million dollars in 1980 turned to a 135 billion deficit in 1988, the deficit peak being reached in 1987, with 154 billion dollars, that at that time represented the 3.6% of the GNP.

How could such a deterioration take place in the external accounts of the United States? The one to blame, evidently, is the economic policy carried out during the period; and, in particular, the first one to blame, though not the only one, is the fiscal deficit. Other explanatory factors are to be found in events which occurred outside the borders of the United States: On the one hand, the economic policies followed in the rest of the industrialized countries, in particular the contractive fiscal policies carried out in Germany and Japan. Secondly, the process of liberalization of international capital movements undertaken in some countries, especially in Japan. Finally, and of great importance, the paralysis of the concession of new loans to developing countries, which forced the adjustment in these countries and the subsequent external deficits in the rest of the world.

It seems that the US fiscal deficit is the main reason that explains the external deficit of the country. Sachs (1988) points out the relation between both deficits, and calculates that an increase of a 1.0% in the fiscal deficit means a deterioration of the current account balance of 0.66%. Other studies also find that shifts in US and foreign fiscal policies accounted for over half of the widening of the US external deficit.

The United States as the World's Largest Debtor

The consequence of the continuous deficits of the balance of payments during the Reagan administration has been that the United States passed, in a very few years, from being a creditor country in the international markets, to being the country with the largest net external debt. Table 3 shows that in 1982 the net investment position of the country was 147 billion dollars, whereas in 1988 the net external debt reached a level of more than 500 billion dollars. That means that, in a six year period, the United States international investment position worsened by 700 billion dollars approximately, and the country became, since 1985, a net debtor, something that hadn't happened for 71 years.⁵

The consequences of the accumulation of such external debt are important: in the first place, the American balance of services, traditionally with a surplus, will suffer great changes in the future, derived from the fact of the worsening of the net creditor position of the country. By making a simple calculation and assuming a US external net debt of 600 billion dollars, this would mean that the annual cost of interests and dividends which should be paid to foreign investors would be a figure in the order of 40-50 billion dollars. To put it another way, to be able to eliminate, nowadays, the deficit on current accounts it would not only be necessary to eliminate the trade deficit, but it would also be necessary to generate a trade surplus of 40-50 billion dollars to pay the debt incurred during the last years.

Another implication of this huge external debt is that the role that foreign investors play within the American economy is going to be much larger in the future than it is today. We have already pointed out the predictable effect on investment: as foreign investors' preferences are different from those coming from national investors--in the sense that they have a bigger tendency towards the possession of shorter-term financial assets--the result of the growing possession of financial assets by foreigners could well mean a decrease in capital formation in the country.

Finally, such a big external indebtedness of the United States creates psychological and prestige problems, as it is difficult for a country with the largest foreign debt in the world to act as a leader when it comes to solving the problem of the external debt of the developing countries and when it comes to solving other important issues of international economic cooperation.

Summary

We could, finally, synthesize the Reagan economic legacy in the following way, according to its positive and negative outcomes: in the negative aspect, the legacy of fiscal deficits that averaged during his presidency the colossal figure of 4.4% of the GNP; the persistence of very high real interest rates, with their negative impact on the cost of capital in the country itself and with their negative consequences on the economies of other countries, developed as well as developing countries; the legacy of a huge balance of payment deficits which, in a very short period of time, converted the United States into the world's largest debtor, once having been the largest creditor; and finally, the inability to stop and reverse the secular deterioration of three relevant variables of the American economy, such as the drop in personal savings, the low growth of productivity and the worsening of the income distribution.

On the positive side, there are two things that must be pointed out: first, the control of inflation, from the two-digit figures of the beginning of the eighties to figures that averaged 4%; in the second place, the creation of employment, even if a major part of it was created in the services sector and with very low remuneration.

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10. On this topic see the seminal papers by Blanchard (1987), Modigliani (1988) and Peterson (1988).

2. There are those who think that, except for inflation, the rest of the macroeconomic indicators have shown a deterioration under the Reagan administration. See Blinder (1987), Phillips (1990) and Krugman (1990), among others.

3. Since 1979, the American manufacturing industry has lost more than 2 million jobs. The reasons must be found in many different factors, among which we must point out the low level of productivity and the behavior of the dollar. On these subjects see

Dornbusch, Poterba and Summers (1988).

4. Concerning the enrichment of the rich, the Nobel Prize winner Robert Solow stated that this was really the final objective of the Reagan economic revolution: "to seek a redistribution of wealth in favour of the wealthy and of power in favour of the powerful". On this issue, see also the recent books by Phillips (1991) and Krugman (1990).

5. The US external debt could be even larger if we assume as foreign capital inflows the annual errors and omissions item of the balance of payments (of the order of 20 billion dollars annually, during the 80's). On the other hand, it must also be said that foreign assets owned by Americans are usually underestimated because they are valued according to their historical cost rather than to their market value.