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USA

The US Economy under the Influence of the Reagan Experiment

by Oliver Landmann, Basle*

Ronald Reagan's first term of office is drawing to a close. What has become of the promises he made in his economic programme four years ago and what is the outlook for the short and medium term?

On 18th February 1981, a month after his inauguration, President Ronald Reagan presented Congress with an economic programme consisting of four points:¹

□ *Restriction of government spending.* During the four years of the Carter Administration (fiscal years 1977-81) Federal expenditure had increased by 13 % a year, a real rate of 4.2 % compared with 2.5 % real growth in GNP. Real expenditure was now to be frozen at the 1981 level until 1985 and thereby reduced from more than 22 % of GNP to 19.3 %. At the same time, there was to be a marked change in the emphasis of expenditure allocation away from transfer payments and other civilian purposes towards the defence budget.

□ *Reduction in the tax burden.* Income tax rates were to be reduced by 30 % over a period of three years and substantial depreciation concessions would be introduced for firms. In this way, Federal revenue as a proportion of GNP was to be trimmed from 21.4 to 19.3 % by 1984, whereas it would have risen to 23 % if policies had remained unchanged.

□ *Reduction in government regulation.* This related not only to curbing government influence on pricing in sectors such as finance, transport and energy, but also to reducing the costs and bureaucratic procedures that had been spawned by the rapid growth in the number of regulations in the fields of environmental protection, product safety and safety at the workplace.

□ *Encouragement of a steady monetary policy oriented towards price stability.* In fact, ever since 1979 such a policy had been the objective of the Federal Reserve Board, which in principle is independent of the Administration. However, by lending it the President's

official support, the Administration intended to ensure continued adherence to the monetarist line and hence to safeguard its credibility.

The thrust of this programme was quite plain: government influence and interference in private economic activity were to be curbed. The Administration not only saw this as an objective of its laissez faire ideology itself but also expected it to produce concrete results in combating the economic difficulties that had increasingly beset the country since the mid seventies and especially in 1980-81. Foremost among these were three unsolved problems:

□ *Inflation.* The loss of price stability had begun during the sixties, but it accelerated considerably during the seventies. The expansionary monetary policy pursued until the end of 1978 and the second oil price shock in 1979-80 helped push the inflation rate to a record 13.5 % in 1980.

□ *Unemployment.* During the upswing that followed the recession of 1974-75 the unemployment rate fell from a peak of 8.5 % to 5.8 % in 1979, but at that level it was still distinctly higher than the average of the fifties and sixties. The combination of the second oil price shock and the severely restrictive policy of the Federal Reserve caused the unemployment rate to rise again, so that it stood at 7.5 % when Reagan came to office.

□ *Stagnating labour productivity.* As in all other industrialised countries, productivity growth in the USA slowed down markedly in the seventies, from an annual rate of 2.8 % between 1950 and 1973 to one of 0.8 % between 1973 and 1979. As a result of the recession, labour productivity did not increase at all between 1978

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¹ Cf. America's New Beginning: A Program for Economic Recovery, The White House, 18th February 1981.

and Reagan's inauguration and at the beginning of 1981 real wages were even below the 1973 level. A satisfactory explanation for this stagnation has yet to be found, but it is beyond dispute that the slowdown in capital formation, the faster growth in the labour force and its changed composition were all significant factors.

The Reagan Administration promised remarkable success on all these fronts. Its projections of February 1981, which are reproduced in Table 1, held out the prospect that real GNP would recover from the recession within three years and would grow at a sustainable long-term rate of more than 4 % thereafter. Over the same period the inflation rate would *gradually* fall back to half its previous level; finally, a balanced Federal budget was promised for the 1984 fiscal year.

As we now know, and as Table 1 also shows, actual events diverged markedly from these projections. A new recession began in the third quarter of 1981; by the end of 1982 it had developed into the worst decline in economic activity since the second world war. Instead of the projected steady decline in underemployment, the unemployment rate rose temporarily to more than 10 %. Inflation consequently slowed down much more quickly than had been expected, so that by 1983 it stood at its lowest level since 1967.

The steep recession was followed by an equally strong recovery, with the result that today, a year and a

half after passing the cyclical trough, not only the inflation rate but also unemployment and GNP growth are relatively close to the projections for 1984. In spite of this success, however, it should not be overlooked that even after two years of very strong growth real GNP in 1984 is still almost 5 % lower than originally forecast by the Administration. Government finances are way off target: instead of the hoped-for balance between receipts and expenditure, there is now a yawning \$200 billion budget deficit, and only a small part of this can be attributed to cyclical factors. In addition, real interest rates have risen far higher than expected to reach a record level of about 6 % in 1984.

Against this background, one must ask what the Reagan Administration actually based its projections on and why things turned out so different in practice.

Shortcomings in Economic Policy Formulation

The doctrine underlying the Reagan programme set out from the premise that the traditional tools of demand management had proved ineffectual and that economic policy should instead devote its efforts towards expanding the scope for supply. The catchword was supply-side economics; essentially, this meant growth policy.

The central tenet of the supply-side school was that the tax-levying state had weakened the incentives for

Table 1
Projections by the Reagan Administration and Actual Developments, 1981-84

	Legacy of the Carter Administration	Projections by the Reagan Administration				Actual Developments			
	1980	1981	1982	1983	1984	1981	1982	1983	1984
Unemployment rate	7.1	7.8	7.2	6.6	6.4	7.6	9.7	9.6	7½ ¹
Inflation rate (consumer prices)	13.5	11.1	8.3	6.2	5.5	10.4	6.1	3.2	4 ¹
Real GNP growth	-0.3	1.1	4.2	5.0	4.5	2.6	-1.9	3.3	6 ¹
Nominal GNP growth	8.8	11.1	12.8	12.4	10.8	12.2	4.0	7.7	10¼ ¹
Growth in M ₁ money supply	6.5	6.0	5.5	5.0	4.5	6.4	8.5	9.0	5.5 ²
(Short-term) interest rates:									
nominal	11.5	11.1	8.9	7.8	7.0	14.0	10.7	8.6	10¼ ³
real	-1.8	0	0.6	1.5	1.4	3.3	4.3	5.2	6
Balance on Federal budget (\$ bn)	-60	-55	-45	-23	+1	-58	-111	-195	-184 ⁴

¹ OECD forecast, OECD Outlook, July 1984.

² First quarter of 1984.

³ July 1984.

⁴ Budget for the 1984 fiscal year.

Sources: America's New Beginning: A Program for Economic Recovery, The White House, 18th February 1981, Economic Report of the President, 1984.

the productive deployment of resources by appropriating an ever increasing share of national product. This trend was to be reversed by the new fiscal policy stance. There were two main effects involved here: first, the *labour supply* was to be expanded, in that the reduction in marginal income tax rates would increase the material rewards of work and discourage the drift into the informal economy. This effect was overestimated. Even at the purely theoretical level it is not clear cut, because the desired substitution effect is offset by an income effect that could easily be the stronger.² Empirical studies have not found that net real income has any overwhelming effect on the labour supply³ – an impact that is most likely to occur in the case of young people and women. However, in the seventies the participation rates for precisely these categories of workers increased sharply, despite stagnating real wages and rising marginal tax rates. Furthermore, as unemployment was still high when Reagan came to office, it is easy to conclude that the mobilisation of additional labour by means of price incentives was neither particularly promising nor especially urgent.

The second aim of the tax cuts was of greater importance, namely to *promote capital formation*. In the second half of the seventies both the saving and investment ratios had declined sharply from a level that was already well below the international average. The supply-side school blamed this fall on the erosion of incentives to save and invest caused by the combination of inflation and the tax system's entrenched adherence to nominal value principles.⁴ Even leaving tax considerations aside, households had to accept that, with inflation accelerating, real yields on their savings deposits were negative. With interest rates at 6.3 % and inflation running at 7.1 %, the real rate of interest averaged –0.8 % in the seventies. For a saver with a marginal tax rate of 30 %, nominal interest after tax still amounted to 4.4 %, or –2.7 % in real terms. Yields were further distorted by statutory interest rate limits on

the usual forms of saving. The result was that households no longer had much incentive to provide funds to the capital market. It was much more profitable to borrow money themselves to purchase durable consumer goods and real estate. Whereas the benefits derived from these quasi-consumption investments are largely tax-free, income from entrepreneurial investment to create productive capacity is subject not only to corporation tax but also capital yield tax or capital gains tax on shareholders. Investing businessmen did benefit from negative real interest rates, which were further accentuated by the tax system, but this advantage was wiped out by the fact that inflation eroded depreciation limits set in nominal terms and generated paper profits on inventories. Both factors increased the corporate sector's real tax burden and therefore reduced the propensity to invest.

Savings Incentives a Failure

The consequence of all these effects was an increasing distortion of the structure of GNP expenditure to the detriment of productive industrial investment. Almost all the elements in the Reagan programme were directed towards removing this distortion: the reduction in the inflation rate, the lowering of tax rates, the dismantling of regulations hostile to investment and the more generous depreciation allowances. The emphasis of the measures was placed fairly and squarely on stimulating private savings. The desire to save was to be strengthened by reducing marginal tax rates and creating new tax-free forms of saving. Reliance was once again placed on the substitution effect produced by relative prices: the rise in real post-tax interest rates was supposed to induce households to postpone consumer spending and hence to make more savings capital available to finance investment. As in the case of the labour supply and for the same reasons, the net effect of a higher rate of yield on savings is ambivalent from a theoretical point of view. Nevertheless, recent empirical studies suggest that savers' interest rate elasticity is greater than had often been assumed.⁵

So far, however, households have not reacted noticeably to the new savings incentives. Despite much higher real interest rates and lower tax rates, the savings ratio has continued to pursue the downward trend that began in the seventies; in 1983 it was down to 4.8 %, its lowest level since 1949. It is a matter of debate whether this means that the price incentives are ineffectual, subject to a time-lag or overlaid by external factors in this case. The spectrum of explanations ranges from the recession via the wealth effect of the

² Understandably, the income effect does not fit the supply-side school's concept. P. C. R o b e r t s, who later played an active part in implementing the Reagan programme as Assistant Treasury Secretary, also described it as being "foreign to the price-theoretical perspective of economic science" (sic!) and even ventured as far as to state that the predominance of the income effect over the substitution effect implied that "all consumer goods are inferior goods" ("The Breakdown of the Keynesian Model", in: *The Public Interest*, No. 52, Summer 1978).

³ Nevertheless see J. A. Hausman: *Labor Supply*, in: H. J. A a r o n, J. A. P e c h m a n (eds.): *How Taxes Affect Economic Behavior*, Washington 1981.

⁴ Cf. *Economic Report of the President*, 1983, Chapter 4.

⁵ M. J. B o s k i n: *Taxation, Saving and the Rate of Interest*, in: *Journal of Political Economy*, No. 86, 1978; L. H. S u m m e r s: *Capital Taxation and Accumulation in a Life Cycle Growth Model*, in: *American Economic Review*, No. 71, 1981.

rise in share prices to demographic factors such as the relative increase in the number of young people of an age to start families and therefore with a correspondingly high propensity to spend.⁶

The proportion of national income that is saved obviously does not depend solely on the savings behaviour of private households and enterprises but also on government expenditure and receipts. It was clear from the outset that the programme of tax cuts in itself would reduce public sector saving, for even the Reagan Administration had at no time accepted the notion associated with the much-quoted Laffer curve that lower tax rates would lead to higher tax revenues; furthermore, as it could not realistically be expected that private consumer spending would remain unaffected by the method of financing government expenditure, public sector consumption should have been reduced in step with taxes if the aim really was to raise the economy's savings ratio. After all, reducing government expenditure was also a high priority of the Reagan programme.

The following question simply remained unanswered: how could the promised expansion of output and employment possibly be achieved if fiscal policy was directed towards reducing the private and public-sector consumption ratios and monetary policy remained committed to its restrictive anti-inflation course? The policy whose declared aim it was to release the driving forces of supply growth was clearly in danger of throttling the demand for that supply. Demand considerations had no place in the theoretical conception of the Reagan experiment, however. The aim was precisely to make a radical departure from the traditional demand-oriented Keynesian pattern of thinking: "A crucial feature of the new approach to economic policy is to reject completely and I hope permanently the Keynesian fear of saving and to recognise that a higher saving rate would be a good thing for the American economy".⁷ The 1982 Economic Report of the President, in which the entire conception is set out in detail, goes a step further by equating foregone consumption directly with capital formation:

⁶ See for example D. Seligman: Why Americans Don't Save Enough, in: *Fortune*, 2nd April 1984.

⁷ M. Feldstein: The Conceptual Foundations of Supply-Side Economics, in: *Supply-Side Economics in the 1980s*, Proceedings of a Conference sponsored by the Federal Reserve Bank of Atlanta and the Emory University Law and Economics Center, Quantum Books, 1982.

⁸ Economic Report of the President, 1982, p. 116.

⁹ This inconsistency between money supply targets and income projections was a focus of Keynesian criticism from the outset. See for example W. Heller: Assessing the Reagan Economic Program, and J. Tobin: The Reagan Economic Plan: Supply-Side, Budget, and Inflation, both in R. H. Fink (ed.): *Supply-Side Economics. A Critical Appraisal*, Fredenck 1982.

"One way to expand the stock of physical capital is for the household and government sectors to reduce their combined demand for current consumption".⁸

The way in which the Administration intended to reconcile the continued slowdown in the *growth of the money supply* with its objectives for economic growth was equally unconvincing. The idea was that the supply-side stimulus provided by the tax cuts should increasingly fill out the constant – or, initially, even rising – nominal growth of GNP with *real growth*, while at the same time the inflation rate would fall owing to a deceleration in the growth of money supply. Two conditions would have had to be met for this scenario to materialise. First, the supply-side effects of fiscal policy and the inflationary expectations conditioned by the monetarist money supply policy would have had to exert a sufficiently strong impact on the price-volume structure of the national product to reduce inflation *without* sacrificing employment, and secondly the predicted growth in nominal incomes while adhering to the money supply targets would have required a fall in the demand for money, which there were no grounds to expect, however. As Table 1 shows, the velocity of circulation of the M_1 money supply would have had to increase by 6-8 % a year between 1981 and 1984 under the Reagan programme, despite the fact that it had previously risen by an average of only 3 % and had never increased by more than 5 % for longer than two consecutive years. This alone cast serious doubts on the envisaged growth of incomes over the short to medium term.⁹

The objective of a balanced budget was obviously jeopardised along with the growth objective, for slower growth in national income also implied slower growth in tax revenue. If the Federal budget was nonetheless to be balanced by 1984, far more sweeping cuts in expenditure would have had to be envisaged. But even the original proposals for savings were already more wishful thinking than a realisable programme. To fill the gap that the tax cuts and additional defence commitments in the years up to 1984 would make in the overall budget, the initial projections provided for savings of \$125 billion in the 1984 fiscal year alone. That amounted to just under 15 % of the expenditure that would have resulted from extrapolation of the Carter Administration's last budget estimate. Given that cuts in the central elements of the social security net, that is to say social security benefits and Medicare, were never seriously considered, that defence expenditure was to be increased and that nothing could be trimmed off interest payments, there remained only a small slice of about 30 % of the overall budget in which savings could

be made. In line with the Administration's ideas of the scale of necessary savings, this slice of "other expenditure" would therefore have had to be cut by half, which was never a politically realistic proposition.

The only notable spending cuts were approved by Congress during 1981. These affected primarily the fields of energy, education and transfer payments to states and local authorities. However, they amounted to only just over one-third of the sum required on the basis of optimistic assumptions. The remainder were either defeated in Congress or were never put forward in concrete terms by the Administration. At the same time, however, the proposed tax reductions met with a far more favourable response and were implemented almost in their entirety, so that the deficits that are now the subject of so much discussion were pre-programmed from the outset.

From the Recession to the 1983-84 Upswing

These inconsistencies contributed to the unusually sharp cyclical swings that marked the period of office of the Reagan Administration. First came the 1981-82 recession, which was attributable to restrictive monetary and fiscal policies. The Federal Reserve had fuelled the recovery from the "mini-recession" of 1980, but in the second half of 1981 it kept the growth of the money supply significantly below its own target range, partly because the velocity of circulation of money in the preceding quarters had risen faster than expected. Fiscal policy had contractionary effects on three counts in 1981:

- On the *revenue* side the programme of tax cuts was still barely making itself felt. It was not until the final quarter of 1981 that an initial 5 % reduction in income tax came into effect. Until then, however, the continued high rate of inflation had continued to push up effective tax rates, so that in 1981 the tax system was taking more purchasing power out of circulation than in 1980.¹⁰
- On the *expenditure* side the planned additional defence spending did not assume significant proportions until the budget for the 1983 fiscal year. By contrast, real consumption by states and local authorities fell in absolute terms until 1982 owing to severe cuts in transfers from Federal sources.
- Thirdly, the scale of *future deficits* was already becoming apparent during 1981, despite the still restrictive fiscal policy. Expectations in this respect had the same kind of effect on the financial markets as the

¹⁰ See the estimates of the cyclically adjusted budget in: Survey of Current Business, No. 12, 1983, pp. 32 f.

Table 2
Monetary and Fiscal Policy from the Second Half of 1981 to the First Half of 1983

	Rate of growth in M_1 money supply (% p.a.)	Federal budget deficit (\$ billion p.a.)		Real GNP growth (in % p.a.)
		in absolute terms	cyclically adjusted	
1981/II	5.0	79.1	68.7	-0.7
1982/I	5.9	110.9	69.8	-2.3
1982/II	11.2	183.3	123.3	-1.2
1983/I	14.5	174.7	115.2	+6.1

Sources: International Financial Statistics, February 1984, line 59 mab; Economic Report of the President, 1984, Tables B-2 and B-75; Survey of Current Business, No. 12, 1983, p. 33.

Federal Reserve's policy of restriction, that is to say they led to higher real interest and exchange rates. The crowding-out effect of the forthcoming fiscal expansion was thus anticipated to some extent, thereby reinforcing the decline in total demand.

In mid 1982 monetary and fiscal policy then simultaneously switched over to expansion: between July 1982 and June 1983 the M_1 money supply grew at more than twice its previous rate and the budget deficit soared not only in absolute terms but also on a cyclically adjusted basis (see Table 2). It was a classic case of pump priming, and its effect was not long in coming; at the start of 1983, after a year and a half of recession, there began the strong recovery in economic activity that has endured until today (mid 1984).

Long-term Effects

The supply-side experiment has demonstrated that there is no such thing as a supply-side policy as opposed to a demand policy but only economic policy with supply and demand-side effects that should both be taken into account. Measures that were motivated by growth policy and designed to mobilise an additional *supply* of labour and capital began by having quite unintentional cyclical effects on the *demand* for labour and capital. Now that the trough of the recession has been left some way behind, however, the question arises as to the longer-term changes that the Reagan experiment has caused, beyond its immediate cyclical effects.

One objective that the Administration achieved sooner than intended was the *reduction in the inflation rate*. It was helped in this partly by the sharp recession but also partly by the fact that the process of deregulation and keener international competition appreciably dampened the growth of wages in a number of key sectors. If monetary and fiscal policy can manage

to prevent the current upswing ending in renewed overheating of the economy, it is quite within the realms of possibility that the loss of jobs during the recession will not have been in vain but can be viewed as the price to be paid for the transition to a period of increased monetary stability.

As far as the growth policy aims of the Reagan experiment are concerned, it is probably still too early to predict the longer-term trend of economic activity that will emerge after the cyclical upheavals of the last few years. However, the prospects are not good for the Reagan Administration to achieve the intermediate goal it has set itself with an eye to faster growth, namely the change in the emphasis of GNP expenditure from consumption to saving and capital formation. It is true that investment has revived normally so far following the abrupt decline in 1982 – indeed, it has picked up slightly faster than the average of earlier cycles¹¹ – but the rapidly declining savings rate has cast a shadow over its future performance. As Table 3 shows, the falling trend in saving that has persisted since the sixties has accelerated in the last few years. A particular weighty factor in this has been dissaving by the public sector, whose deficit spending in 1982 and 1983 absorbed about 70 % of net private domestic saving. Unless radical corrections are made in revenue or expenditure, the financing shortfall in the Federal deficit must be expected to remain at about 5 % of GNP until the end of the decade.

Opinions are divided on the seriousness of the prospects of such lasting imbalance. Martin Feldstein has predicted dramatic consequences: "A budget deficit of 5 % of GNP would absorb an amount equal to nearly all net saving and would virtually eliminate capital accumulation as a source of productivity growth and rising real incomes".¹² Feldstein's implied diagnosis is

that the government's borrowing requirement, which is interest rate inelastic, would so raise the cost of credit that private investors could no longer compete for funds and would have to forego implementing productive investment projects.

By contrast, the more dogmatic supply-side economists, who have had the upper hand within the Reagan Administration up to now, believe that the tax increases that would almost inevitably accompany a return to sound public finances would cause *more* damage than the budget deficit itself. This group refutes the connection between the deficit and the cost of credit with the argument that interest rates are finance market prices that are determined not by the equilibrium between *flows* of "investment" and "savings" but by equilibrium in the *stocks* transacted on the financial markets, in comparison to which the budget deficit is very small.¹³ In their view, the high interest rates therefore reflect not the government's borrowing requirement but investors' anxiety about inflation, which has still not been dispelled in the light of their previous experiences.

This is an explanation that fails to convince, because a lack of confidence in the Federal Reserve's stabilisation policy would be bound to show up not only in the capital market but also in the foreign exchange market. In fact, the dollar has remained persistently strong against other currencies, which indicates that the high nominal interest rates are also high in real terms and do not reflect a hidden inflation premium.

Feldstein's claim that the savings shortfall is in danger of becoming a serious constraint on capital accumulation raises the Keynesian question whether additional investment does not itself generate the saving required to finance it. If we look beyond the short term of the Keynesian multiplier, there are two mechanisms that might induce such saving: first a redistribution process à la Kaldor, during which rising prices raise company profits, thereby enhancing their *self-financing ability*. Conditions are favourable for this mechanism in that nominal wages in the USA react rather sluggishly to changes in the level of prices. However, it would be an illusion to rely on corporate saving to fill the gap permanently if households and public authorities do not save, for the implied functional income distribution would be bound to clash sooner or later with equilibrium conditions in the labour market.

Table 3
Investment and Saving since 1965^a

	Sources of savings		Uses of savings	
	Net private domestic saving	+ Capital imports	= Net private domestic investment	+ Public-sector deficit
1965-69	8.3	-0.3	7.6	0.3
1970-74	7.4	-0.1	7.0	0.5
1975-79	6.9	0.1	6.0	1.1
1980	5.4	-0.2	4.1	1.2
1981	6.1	-0.1	4.9	0.9
1982	5.3	0.3	1.8	3.8
1983	5.8	1.1	2.8	4.0

^a As a percentage of gross national product. Divergences from circular flow identity are due to statistical discrepancies and rounding.
Source: Economic Report of the President, 1984.

¹¹ Cf. Economic Report of the President, 1984, Table 6-2, p. 177.

¹² Wall Street Journal, 15th July 1983.

¹³ See for example J. Rutledge: The "Structural Deficit" Myth, in: Wall Street Journal, 4th August 1983.

Another safety valve that relieves the pressure of public sector deficits on investment activity is probably of greater importance – namely *capital imports*. In the last few years this source of finance has grown considerably and is now equivalent to about 2 % of GNP. The current account deficit, which is the real equivalent of an inflow of capital, is being sustained by the high real exchange rate and by the cyclical disparity between the USA and other countries. It does ease the dilemma between non-consumption and stagnating capital formation, but it damages industries exposed to international competition and threatens to consume in a matter of only a few years an international creditor position that has taken decades to accumulate, which has a similar impact on *real income growth* as the failure to invest at home.

Of course, there are also limits to the volume of capital that can be imported. Experience has shown that, despite international capital flows, a country's investment ratio does not for long diverge from the order of magnitude dictated by *domestic saving*.¹⁴ But there is no evidence that the system's built-in adjustment mechanisms will operate particularly quickly. The exchange rate, interest rate and wealth effects that the modern portfolio balance theory leads us to expect to result from a lasting change in the net external position all work in the direction of current account equilibrium, but experience so far has shown that they are not of great quantitative importance.¹⁵ Provided economic policy does not deliberately steer in the opposite direction, the present external imbalance is most likely to be corrected by the elimination of the international cyclical disparities.

Conclusion and Outlook

The conclusion that can be drawn is that the Reagan programme, or rather the part of it that survived the political process, has produced a pronounced *consumption-biased* structure of GNP expenditure, the direct opposite of what was probably its most important objective.

The *micro-economic* allocation effects that should have been produced by the tax concessions, which were intended as price incentives, are being completely overshadowed by their counterproductive *macro-economic* circular-flow effects. Hence in present

circumstances the starting point for raising the saving and investment rates is probably less the removal of distortions in relative rates of return than the curbing of public-sector dissaving.

Opinions are divided on the short to medium-term outlook for the US economy. Whereas the supply-side school sees the strong upswing in the last year and a half as emphatic confirmation of its view, more sceptical observers point to the risks associated with the budget deficits, the high interest rates and the dependence on continued imports of capital. However, none of these factors poses a direct threat to the upswing. The expansionary fiscal policy is still a mainstay of demand growth and the rise in interest rates is the allocative mechanism that makes room for private and public consumption to expand in a time of increasing capacity utilisation rates.

The fact that "America's current prosperity is highly dependent on the good will of foreigners" because "huge sums of imported capital allowed the nation . . . to finance a consumer spending spree"¹⁶ does not mean that a change of mood among international investors to the detriment of the dollar (which could occur at any time) will instantly bring the consumer boom to an end. A portfolio switch back into Deutsche Mark, yen, Swiss francs and so forth is by no means synonymous with a reversal of existing capital flows; initially it would simply force a revaluation of outstanding liabilities and receivables, in other words a dollar devaluation. The indirect effects of such an exchange rate adjustment, that is to say the medium-term reaction of import and export volumes, would nevertheless speed up the correction of the current account imbalance and hence the reduction in capital imports.

Economic policy will have a difficult problem to solve if the restoration of sound public finances is to be tackled seriously after the forthcoming elections, a fairly likely occurrence whatever the verdict of the electors. Substantial cuts in expenditure and/or tax increases, which cannot be decided until the first half of 1985 at the earliest, will not have their full impact until the current upswing has begun to lose momentum. If there is not to be a repeat of the 1981-82 episode, when an undoubtedly desirable growth policy geared towards long-term effects initially merely destabilised the economy, the change in the course of fiscal policy will not only have to be carefully dosed but also closely co-ordinated with monetary policy. There is naturally some justifiable scepticism whether so much fine tuning can succeed.

¹⁴ Cf. M. Feldstein: Domestic Saving and International Capital Movements in the Long Run and the Short Run, in: European Economic Review, No. 21, 1983.

¹⁵ With regard to the exchange rate effect, see M. P. Dooley, P. Isard: The Portfolio-Balance Model of Exchange Rates and Some Structural Estimates of the Risk Premium, IMF Staff Papers, No. 30, 1983.

¹⁶ As expressed by Newsweek, 27th February 1984.