"A SIGNIFICANT TURNING POINT"

Speech by Bosworth M. Todd, Jr.
Bank Administration Institute
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A week ago last Thursday I attended a small dinner in New York hosted by my friend, the economist, Pierre Rinfret. His purpose was to interpret for his clients the economic implications of Reagan's victory and the Republican landslide in Congress. He said that he was fooled and even the pro's were fooled. Senator Hatch told him the Republicans might get 46 seats in the Senate. Instead they gained]2 seats and now control it with 53. Nixon told him he thought Carter could win. All his Republican friends thought that even if Reagan squeaked out a victory he would face a hostile Congress. Democrats still control the House but the Republicans percentage has jumped from 37% to 44%. Tip O'Neil will still block legislation he doesn't like but he cannot ignore the fact that there are enough conservatives among his own Democratic Party in the House to give Republicans, as was pointed out in yesterday's New York Times, effective control on such key matters as government spending.

This election was quite a milestone. It was not a non event. The results were stunning - enough so that the implications will take time to sink in. When an obscure, conservative politician such as Alphonse D'Amato wins a New York Senate seat something remarkable is going on. I conclude Reagan has a mandate - not so much for conservatism because of ambiguity as to what that means - but a mandate for repudiation of old liberal solutions.

I was particularly inspired by comments of one gentleman during the discussion which followed Rinfret's talk. The jist of what he said was: "I'm more optimistic now than I've been in a long time. This is a major turning point for the American people. We have the resources, the people, and the technology. I expected this turnaround to come but it has occurred more quickly than I dreamed. For the first time since World War II we are ready to accept leadership again, to once again look beyond our special interests to the challenge of solving bigger problems."

This 78 year old gentleman who spoke so optimistically was none other than Thomas C. "Tommy the Cork" Corcoran, one of the key "brain-trusters" in President Roosevelt's New Deal, noted for his quick mind and Irish wit.

Evans and Novak last week said this was the most important election result since the end of World War II. They said that hile Carter's unpopularity and the hostage issue were factors, more important were resentment over high inflation and inadequate national defense. They also suggest the Democratic Party is in disarray - with Mondale and Kennedy struggling for leadership roles within the Party, yet someone closer to the new mainstream, such as surviving Senator Hart (Col.) or Ohio's big winner, Senator John Glenn is likely to emerge.

What can we expect from Reagan? First, a tax cut. A 30% reduction in personal income taxes over three years and accelerated depreciation allowances for business is likely.

Second, reduced Federal spending. This means gradual dismantling of the Department of Energy and Department of Education, a freeze on Federal hiring and a cut in spending by Federal agencies.

Third, an easing of government regulations. This means relaxation of regulations such as pollution controls, in order to stimulate expenditures for research and for new plant and equipment.

Finally, an increase in defense expenditures. We'll see increased expenditures for upgrading military pay levels and benefits, in order to attract and retain better educated and highly skilled personal as well as additional funding for conventional arms and the MX missile.

In addition, we'll see more rapid decontrol of oil and gas prices, a lowering of minimum wage for teenagers, incentives for business expansion in high unemployment areas.

Emphasis will shift from income redistribution and government solutions to our problems toward one of growth and private sector solutions through investment incentives, less regulation, and lower taxes.

I think, therefore the economy will improve more rapidly in the years ahead than a cynical businessman now expects. The worst of our economic misery should be behind us after this year. 1981 will be a transition year. By 1982 the economy should be showing clear evidence of genuine recovery from years of stagflation, in other words, high inflation and high unemployment.

We look for the recovery to continue, albeit at a sluggish pace. Since early summer, recovery has been underway following a sharp, but clearly incomplete recession in the first half of the year. Money supply recently reaccelerated after falling to unsustainably low levels in the spring. Inflationary fears revived, leading to a surge in demand for credit and a sharp jump again in interest rates. Despite the Fed's seemingly stop/go approach toward monetary policy, on balance Volcker has made plain his unwillingness to finance a renewed burst of inflationary spending.

Late Friday, the Federal Reserve raised, from 11% to 12%, the rate it charges member banks to borrow from it and added a two percentage point surcharge for large, frequent borrowers. Their tighter money policy in recent months has already slowed the increase in money supply. Coupled with the fragile state of the recovery (retail sales declined 1/10 of 1% in October, inventories are still excessive) if this tight money policy is continued for a more than a month or two it risks turning the economy down again for a double dip, a "W", before the recession runs its course.

Interest rates may stay at these near record levels for the time being, risking a brief downturn in areas like autos and housing. But if these temporary stresses in the economy result in getting money supply, and hence inflation, under control, the cost will be small for significant long run benefits. This means disinflation, declining rates of inflation, and lower interest rates. It also means economic growth. It's long overdue.

Next year I agree with consensus forecasts that GNP, adjusted for inflation will rise about 2%. That's not much. GNP generally rises, in real terms, about 7 1/2% in a year after a recession. Most economists agree that the underlying rate of inflation, as measured by the rate of labor cost escalation, is 9 to 10%. Recently exogenous shock factors, either food costs, energy, or housing have added two percentage points or more to the underlying rate. Since this base rate of inflation was no lower at the end of this last recession than when it began we had, as Arthur Burns put it, a "wasted recession". Inflation did not come down. Burns also points out that our economic prospects will improve dramatically if we work seriously on reducing inflation. The most basic requirement is to create general confidence that anti-inflationary policies will be pursued resolutely by the Administration and in ways that encourage business innovation and investment.

Alan Greenspan, a key member of Reagan's economic team, said in a similar vein: "A major policy requirement of the Administration is to convince financial markets that it is serious about inflation."

I'm optimistic that we'll get inflation under control. In contrast to Carter's emphasis on short run gains in employment, generally to the long run detriment of the economy, Reagan seems oriented to dealing with the deep seated problems of inflation and economic stagnation.

The 70's were a decade of economic failure. Americans worked harder than ever before - 60% of adults are now employed - a record - yet reward for this effort has shrunk. Growth of real GNP for employed workers in the 70's (0.85%) was a fraction of the normal gains (2.26%) in the two previous decades. Inflation eroded real wealth of society's most productive members while government programs benefited those least productive.

Washington's priorities in recent years produced dismal results:

- Present consumption was favored at the expense of future consumption. Investment lagged as consumers sought to maintain living standards by drawing down their savings rate.

- Non-producers have been rewarded. The real burden of taxation has hit the middle class to finance a massive increase in transfer payments, primarily social security, which have doubled in real terms in the past 10 years and are scheduled to go still higher. The market value of savings invested in a long term government bond dropped more than one-third in the 1969-79 period.

- Since redistribution of income has been the primary concern of government it's not surprising that growth has suffered.

I believe the sharp 1980 recession, the high inflation, and the dramatic election results represent the early stages of a reversal for the better of forces that in the past have placed the American economy in its present dilemma of inflation, slow growth, excessive oil imports, and weakened military posture. I say that because:

- Policies of redistribution of wealth rather than growth run counter to basic self interest.

- Taxpayers outnumber beneficiaries of transfer payments by a substantial margin.

- Individuals are, on balance, creditors and not debtors, with \$3.8 trillion in financial assets, and \$1.3 trillion in debts. Three-fourths of these assets were fixed income, largely held by the working middle class.

Since the early 50's the entire real growth in the Federal budget has been in transfer payments (Social Security, income maintenance, food stamps, Medicare, etc.). Clearly the recipient of these payments has been singled out for political favoritism over the workingman who has tried to safeguard his savings in government bonds where values have steadily eroded.

I think that's going to change. This means a later retirement age than 65 perhaps, also the taxation of Social Security benefits, and possibly the removal of automatic escalation of benefits for inflation.

Slowing down the growth in transfer payments in this way paves the way for lower budget deficits, less inflation, reduced tax rates, and more rapid economic growth.

Skeptics express doubts Reagan can cut taxes, raise defense spending and balance the budget. Many people forget that the Kemp-Roth Bill did include controls on growth of government spending, and included measures reducing Federal spending as a portion of GNP over three years. Then too, you cannot ignore the stimulative effect tax cuts have on the incentive side toward raising tax revenue. It's not as well documented on the personal side, although results from the Puerto Rican tax cut experience are encouraging. Furthermore defense spending is only 20% of total Federal spending. So, if you slow the growth of the other 80%, you can still raise defense spending while cutting taxes without doing mischief to the budget.

I conclude Reagan has effective control of Congress; a mandate to abandon old liberal policies. We'll see a shift in emphasis to the private sector to solve our problems; via tax cuts, reduced spending, oil and gas decontrol. Obviously we'll see more emphasis on defense. While 1981 is a transition year in the economy, by 1982 we should be experiencing lower inflation, higher real growth. We face a few months of credit squeeze now to get inflation back under control. Inflation in the 70's hurt society's most productive, helped the unproductive. Reagan's economic policies will reverse this emphasis. I expect to see slower growth in transfer payments, for example. Finally, I believe Reagan can juggle a tax cut, and more defense spending, while still working toward a balanced budget.