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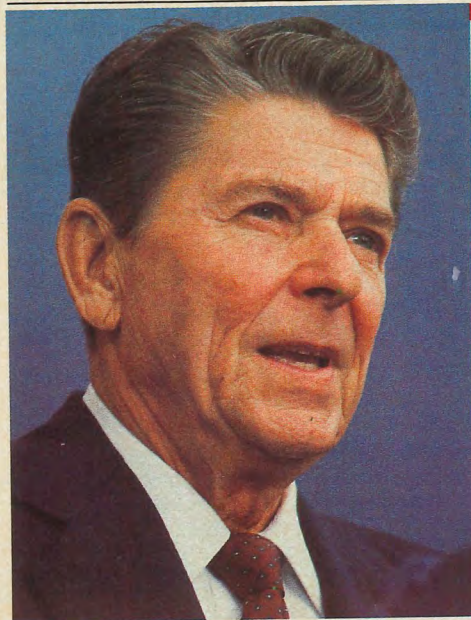
REAGANOMICS

The Confidence Gap



- Wall Street Votes No
- The Black-Hole Budget
- The Interest-Rate Squeeze





Larry Downing—NEWSWEEK

'We never promised it would be easy, and we never promised it would be quick. We can't be stampeded now by frustration or fear. We have to stay on a steady, long-term course.'

—Ronald Reagan



James Nachtwey—Black Star

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'It's time indeed that the financial markets realize that they're playing a very dangerous game. They are voting the wrong way and they are voting themselves right down a hole.'

—Howard Baker



John Fica—NEWSWEEK

Reagan's Confidence Gap



It was the worst bond market in more than two decades, said one veteran trader—and given the unrelenting gloom on Wall Street, there seemed little room for argument. In little more than a month, the mood among the nation's moneymen had shifted dramatically—a new collective judgment that the Reagan revolution had brought with it a dark side of spiraling interest rates, economic dislocation and higher inflation. The message was reinforced at the grass-roots level by Republican congressmen, just back from the summer recess. Their constituents' concerns, as Illinois Rep. Thomas Railsback put it, could be reduced to "two words: interest rates." Suddenly, Ronald Reagan faced what was arguably the most difficult job of his young Presidency: ending a budding crisis of confidence that afflicts his own prosperous constituency, runs the risk of spreading to Middle America and threatens to undo his economic program even before it gets off the ground.

The President's immediate problem was painfully clear. Driven by sky-high interest rates and his own tax-cut program, projections for the Federal budget deficit were spinning wildly higher. At the weekend, Reagan gathered up his briefing books and helicoptered to Camp David to consider his budget-cutting options—a \$15 billion dip into spending plans for fiscal 1982 and at least \$74 billion in cuts for fiscal '83 and '84. The question was whether his new budget totals would appease skeptical investors—and after a Saturday evening announce-

ment that Reagan planned to trim defense spending only \$13 billion over the three years, the answer from Wall Street seemed likely to be "no." The view from the Street was that Reagan's fiscal policy was fighting a tight-fisted monetary policy (page 29)—and that the give would have to come from the White House, not the Federal Reserve. "We need to bring the deficit down very sharply," said Henry Kaufman, the highly respected Wall Street economist (page 32). "We are in a very difficult position, from which we have limited chances to extricate ourselves unless we are willing to undertake draconian measures."

Skepticism and jitters endanger his economic program and force him to seek even bigger budget cuts.

Reagan's own position in the face of the growing upset was to counsel cool—and in meetings with his Economic Advisory Council and his full Cabinet, he pledged his commitment to "a steady, long-term course." His aides, eager to underscore the point for public consumption, took the extraordinary step of issuing a batch of Presidential quotations from the Cabinet session to the White House press corps. "Some people are frustrated because we don't see instant recovery," Reagan told his Cabinet, but "we never promised it would be

easy, and we never promised it would be quick." The goal, he insisted, remained unchanged: a balanced budget by fiscal '84.

His allies on Capitol Hill, however, were less disposed to maintain the façade of sturdy calm—and they set out to look for scapegoats. The immediate target was an extraordinary one for political exponents of the free market. After a strategy session with Reagan at midweek, Senate Majority Leader Howard Baker said he found it "absolutely appalling" that the nation's financiers were "voting with their money" against the Administration's program. "They're voting the wrong way," Baker said, hinting darkly that the financial markets have got to "realize they're playing a very dangerous game." Other Republicans were more explicit, threatening legislation to impose new controls on credit, expand the regulatory powers of the Federal Reserve or levy a "windfall-profits tax" on excessive interest income. "The financial community has got a hearing problem," blustered Kansas Republican Robert Dole, chairman of the Senate Finance Committee. "They need a hearing aid—and a swift kick in the rear."

Victims: But the exercised Republicans seemed to be missing the real point. Interest rates had ballooned the estimated cost of government borrowing by more than \$5 billion for fiscal '82 alone—an amount very nearly as much as Reagan and his men were preparing to cut from the budget. The consensus in the private sector was that the '82 Federal deficit would surpass Reagan's target of \$42.5 billion by perhaps \$20 billion, even with the second wave of cuts now on the table, and the Congressional Budget

Office compounded those grim forecasts by predicting that the President's promise of a balanced budget in fiscal '84 might fall \$50 billion short. In Wall Street's worst-case vision of the future, the yawning gap between spending and revenues would continue to place upward pressure on interest rates. The visible victims of today's punitively high rates—the auto and housing industries, savings and loan institutions, small businesses and the capital-raising stock-and-bond markets—would become tomorrow's terminal patients, leading to an economic contraction and rising unemployment.

Even though they hardly shared Wall Street's harsh judgment of Reaganomics, the President's friends on Capitol Hill recognized the dangers posed by the no-confidence vote in the money markets. "Something has got to give within 60 to 90 days," said House Minority Leader Robert Michel. The fear was that Reagan's high personal popularity might begin to slip on economic issues, hurting GOP candidates in next year's elections. The lightning rod was plainly interest rates—and for the moment, the folks at home were still not holding Reagan accountable. Dole of Kansas, for example, heard unending complaints as he toured his state. Exasperated, he wound up calling Federal Reserve chairman Paul Volcker, then handing the phone to farmer Kalo Hineman of Dighton, Kans. "These interest rates are stretching us to the breaking point," Hineman told the Fed chief.

The proposed reprisals against Wall Street, which surfaced last week as remedies for high rates, were mostly rhetorical—and the real work in Washington boiled down to how and

where to shrink the budget. One solution, briefly popular, was to pass the buck back to Reagan by reviving in limited form the President's power to cut spending by "impounding" Congressional appropriations. But Michel said impoundment, banned by Congress several years ago, was "more of a fallback position" in case Reagan's new spending reductions failed to pass.

For the President, it was still a trifle early to worry about the Congressional pros-

pects: instead, he was engaged as referee in an intramural battle between budget director David Stockman and Defense Secretary Caspar Weinberger over the amount of Pentagon spending. Early last week, Weinberger's spokesmen were still maintaining that no cuts would be considered in the '82 defense budget—but that was before Weinberger and Stockman sat down with Reagan to present their respective cases. The Defense Secretary went first. Armed with charts showing tanks and airplanes sawed in half, he offered three options, including one that depicted a scarifying picture of the impact on U.S. forces: elimination of 37 Navy ships, delays in procurement and—perhaps coincidentally—deactivation of the Army division to which Presidential counselor Edwin R. Meese's son is currently assigned.

Ripples: Stockman had just one option—a plan for a \$30 billion cut over fiscal years 1982-84. Reagan heard Stockman's case, then left two days later to make up his mind—armed with three OMB briefing books and a 100-page blue binder from Weinberger. In fact, the President had already made a tentative decision—and at 2 p.m. Saturday, he phoned Weinberger and Stockman to break the news. Reagan's decision to cut projected outlays by a mere \$13 billion over the three-year period was a better-than-nothing victory for Stockman, but the modest figure seemed likely to cause further disquieting ripples on Wall Street—and it placed a greater burden on nondefense cuts to keep the budget deficit in check.

Reagan's final choices for new non-defense cuts were still uncertain. The OMB wanted to place a 10 per cent downhold on the executive branch's

'My brokers are Reagan, Regan and Stockman and when they talk—'

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discretionary spending and to increase user fees for government services. Reagan also intended to carve another \$4.1 billion from domestic programs. Depending on exactly what is cut, the President could jeopardize his standing with the "Gypsy Moths"—the Northeastern Republicans in the House who stood by him in the earlier budget and tax votes. "I would resent any cuts in areas in which we made a deal with the Administration," said Rep. William Green of New York. "It would be a breach of faith."

As the Republicans wrestled with the

budget, the Democrats seemed almost passive observers: as they saw it, Reagan had painted himself into a political corner. At House Speaker Thomas P. (Tip) O'Neill's direction, they prepared to lie back and watch the Republicans flounder through the budgetary thickets. "Our over-all agenda should be to get out of town quickly," said New York liberal Rep. Thomas Downey. "We have a terrible capacity to screw up, and he has us to blame." On the eve of an election year, the Democrats intended to keep the focus on Reagan's economic stewardship—and to that end, they scheduled a series of road-show hearings on the state of

the economy in general and the impact of interest rates in particular.

What the Democrats seemed certain to hear was a gathering echo of Wall Street's plaint—that interest rates are punishing the economy. Their opponents were committed to what Majority Leader Baker called a "riverboat gamble" that the new show of fiscal discipline would turn the markets. But the stakes involved transcended party politics: on the table was nothing less than the health of the U.S. economy.

TOM MORGANTHAU with THOMAS M. DeFRANK, ELEANOR CLIFT, JOHN J. LINDSAY, GLORIA BORGER, DAVID C. MARTIN and HOWARD FINE-MAN in Washington and ERIK IPSEN in New York

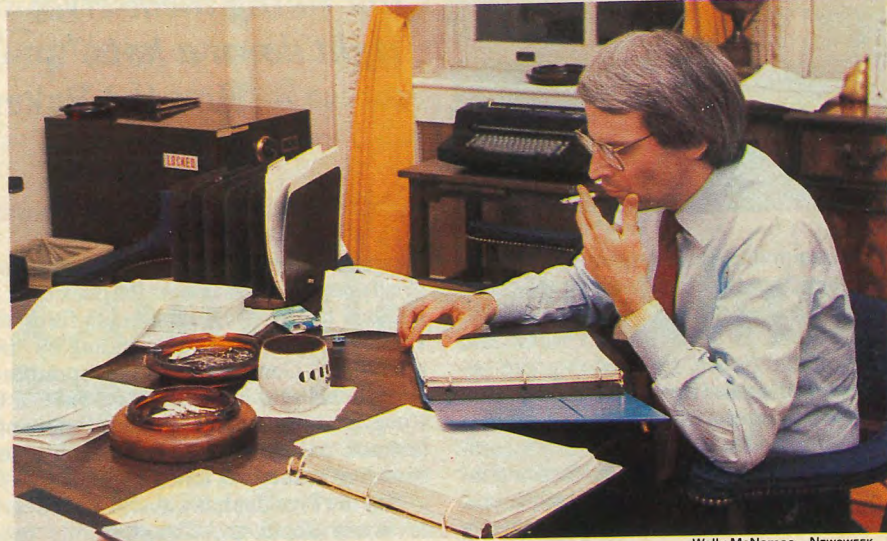
Stockman: At It Again

After a month or so out of sight, David Stockman was back at the national chopping block last week, and with a sacred cow in tow: the Pentagon. Against most Republican instincts and all of the party's campaign promises, the director of the Office of Management and Budget persuaded the President that, given the prospect of mounting Federal deficits, even the untouchable defense budget would have to budge. The final revisions probably will be billed as a compromise with Defense Secretary Caspar Weinberger, but the fact that Weinberger had to yield at all was a victory for OMB, and a sign that Stockman has turned his unglamorous post into a seat of real power.

Historically Washington has greeted OMB directors with the enthusiasm reserved for drunks in church, as Weinberger himself found out when he held the job in the Nixon Administration. (He earned the unaffectionate nickname "Cap the Knife" for his dutiful dismemberment of budget requests.) Stockman was also called unpleasant names at first, and he reinforced the negative impression by treating even his own party's Congressional leaders highhandedly. Recently, however, he has suppressed his loner's disposition and near-compulsive work habits long enough for some socializing with Senate Majority Leader Howard Baker and House Minority Leader Robert Michel, among others, and a Michel aide proclaims that all is "love and devotion" between the two men.

High Marks: Stockman has also moved his office beyond its traditionally defensive function—holding the line against further government spending—to an offensive role as the primary instrument of Reagan's turn-back-the-clock economics. For his successes—the sweeping budget cuts so carefully planned that he was able to predict the arcane parliamentary maneuver on which victory would be won—he has earned high marks. In the process he has become, as an outgoing OMB official puts it, "a genuine star," much in demand for after-dinner speeches and campaign appearances for GOP candidates. Most important, his stock at the White House has survived the decline on Wall Street, even though that slide calls into question his own confidence in the wonders of the Reagan revolution.

Stockman is dismayed by the markets' disarray. "The interest-rate thing was a genuine shock to him," says one close associate. But he is undeterred from his long-term strategy. Unlike many supply-siders, Stockman believes that budget deficits *do* mat-



Wally McNamee—NEWSWEEK

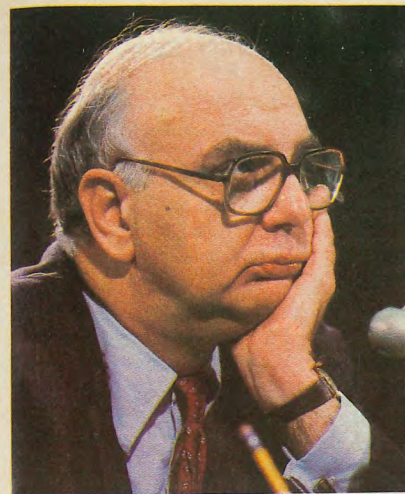
The OMB boss at work: The market may fall, but his stock remains high

ter—and that the Reagan tax cuts serve as useful prods, forcing Congress to make further spending reductions as the only alternative to giant doses of fiscal red ink. "If a man's overweight," Stockman likes to say, "you may solve the problem by persuading him to cut down eating. But a surer way is to cut off his food. That works every time." He still believes that the Reagan program will fulfill its promises, though probably not before 1983, if only he is allowed to plunge the knife into previously off-limits budgets like those for defense and social security.

So David Stockman will stick to his seventeen-hour days, his 4:30 a.m. risings and his skimpy doughnut breakfasts, his torso getting a little thinner and his razor-cut hair a little grayer, while everyone around him struggles to keep up. "If I have ten minutes on Dave Stockman's calendar," says one top assistant, "I rest up before I go in to see him, and rest up after I've been in." He works his staff hard, but complaints are rare. One senior civil servant at OMB is grateful that there finally is a director who doesn't need to be brought "up to speed." Stockman, he says, "was already over the speed limit when he got here."

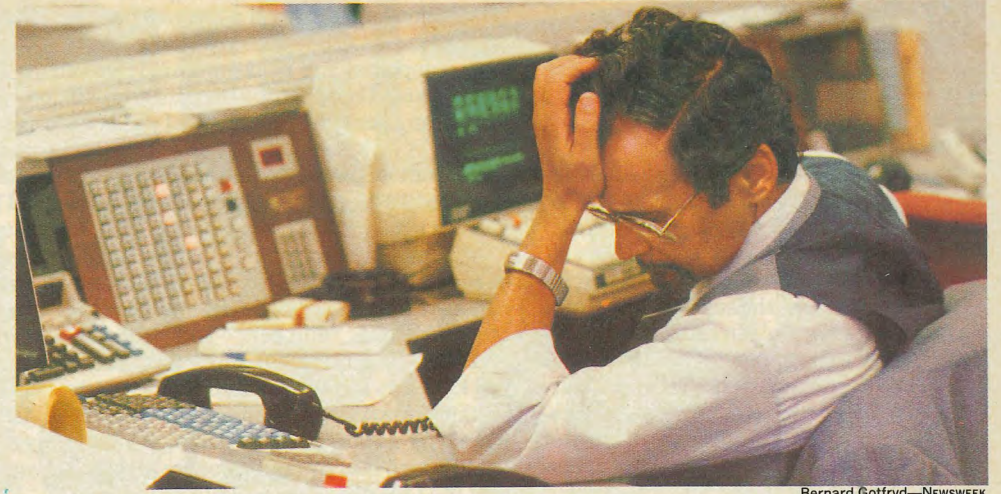
His tenacity is such that he will pass up a tempting opportunity to unseat liberal Democratic Sen. Don Riegle in his home state of Michigan next year, though he is considering a 1984 run against the equally liberal Sen. Carl Levin. In the meantime, the revolution won't start without him: "We've never cut budgets like this before in our history," says the senior civil servant at OMB, "but we never had a Stockman before, either. If there had been no Stockman, Reagan would have had to invent him."

PETER McGRATH with RICH THOMAS and HENRY W. HUBBARD in Washington



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Fed chairman Volcker (left), Manhattan broker: Fears of a clash between monetary and fiscal policy—and a bigger crunch ahead



Bernard Gotfryd—NEWSWEEK



Why Wall Street Worries

From the outset, Ronald Reagan's economic strategy has depended heavily on psychology. If the financial markets believed that the President's economic minimalism would produce better times ahead, his planners reasoned, a massive surge of productive investment would make the prophecy come true. But so far the markets—"the brains, the nervous system of the country," in budget chief David Stockman's words—remain unconvinced. Bruised by a decade of rising inflation rates and battered by Washington's stop-and-go policies, investors are deeply doubtful about Reagano-

than ever—and even more pressure on credit markets as the U.S. Treasury moves in to finance them. "The new supply-side view is that deficits don't matter," says Arnold X. Moskowitz, first vice president at Dean Witter Reynolds. "We think that they do—deficits are simply not the hallmark of good economic management."

For its part, the Reagan team thinks Wall Street is overreacting—and some private economists agree. The Administration's economic program does not take effect until October, and its supporters argue that proclaiming it a failure so prematurely is unreasonable. Economists inside the government and out also find considerable comfort in the economy's continued strength—especially a slowdown in the annual inflation

rate to about 9 per cent from the double digits of last year. And even though the government has piled up deficits totaling \$414 billion over the last decade, Reagan supporters stress that the deficit as a percentage of the gross national product—the entire U.S. output of goods and services—is actually declining (charts, below).

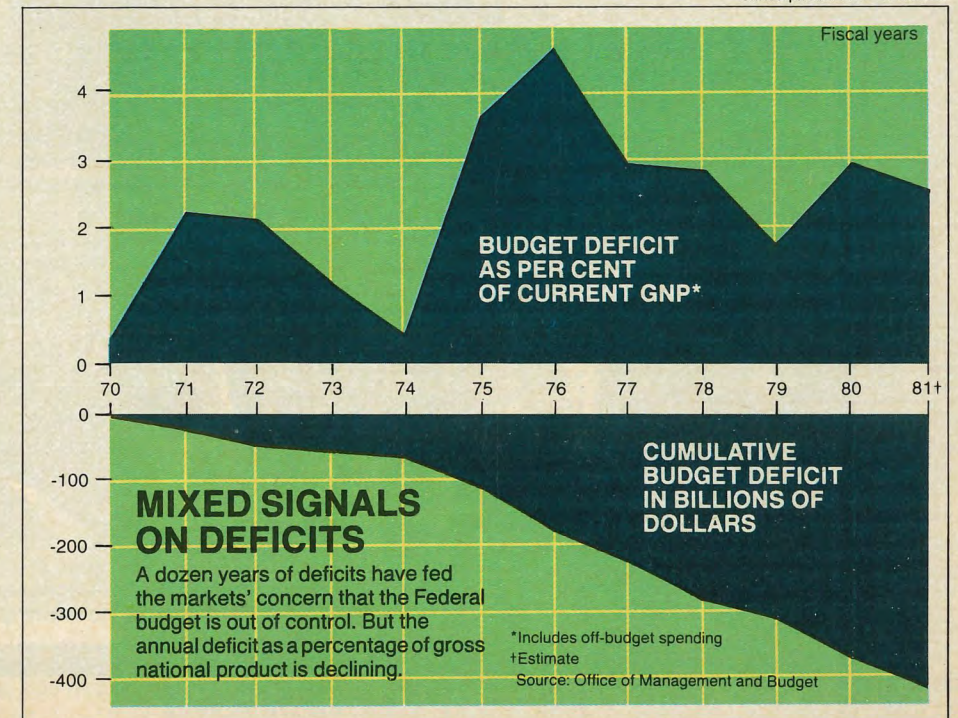
Panic: Still, supporters of the Reagan policies know they cannot afford to ignore the markets' concerns. Unless interest rates decline, industry will not start the capital-spending splurge that Reaganomics prescribes to spur economic growth; last week the Commerce Department reported that corporate plans for capital investment, adjusted for inflation, have barely budged since last year. "What Reagan has to do now

Christoph Blumrich—NEWSWEEK

As the financial markets see it, the Reagan program may make an already bad economy even worse.

mics. And their skepticism, in turn, threatens to scuttle the President's program before it really has a chance.

The symptoms of Wall Street's disaffection are unmistakable: interest rates, adjusted for inflation, are at their highest levels since the Great Depression, the long-term bond market is near collapse and the stock market is slumping (chart, page 30). The reasons for the disarray are equally clear. As the Street sees it, Reagan's monetary and fiscal policies are battling one another, putting a powerful squeeze on the economy. Perhaps more important, his budget numbers just don't add up. The prospect of a gargantuan tax cut coupled with a huge increase in defense spending seems to suggest bigger Federal deficits



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is arrest the panic," says economist Allen Sinai of Data Resources, Inc. "It will take a series of tough responses to make people believe in his program."

There is a range of options on the Administration planning board, from modifications in the tax code to a suggestion from Congressional critics that credit controls might be in order. But some of the possibilities are anathema to the supply-siders, others might alienate Wall Street still further—and almost all promise to be difficult to enact. The skepticism in the financial markets runs so deep that no remedy is absolutely certain. "We are dealing with a lot of incredibly wounded feelings," says Dan Napoli, trading director for government bonds at Merrill Lynch. "That negativism has to be jolted out of the system, like taking someone with a mental condition and prescribing shock treatments."

Losses: The bond markets need the therapy most. Buyers of new long-term bonds bet that interest rates will fall, raising the market value of their fixed-yield investments. But in recent years many investors have been losing that bet. "The losses have been absolutely mind-boggling—tens of billions of dollars' worth," says Jim Grimes, head of New York municipal bond-trading operations for Bache Halsey Stuart Shields,

Inc. According to Napoli of Merrill Lynch, big institutional buyers—especially insurance companies and banks—have deserted the market. Those few customers who are still buying demand astronomical yields for the risk of locking in twenty years of losses, forcing interest rates higher than ever. An Aa-rated utility issue, for example, now yields a staggering 17.5 per cent.

Meanwhile, corporations that are unable to raise capital in the long-term bond markets have turned to short-term borrowing in unprecedented numbers—and the increased competition for short-term funds has kept upward pressure on interest rates in those markets as well. Many analysts warn that a time bomb is ticking away: at the first sign that interest rates are easing or that the U.S. economy is finally stabilizing, corporations will rush back to long-term bonds. That, in turn, would prevent any substantial fall in long interest rates.

The mood in the stock markets is slightly less foul, although high interest rates have lured many investors out of common stocks to more lucrative money-market funds. Before a rally last week, the Dow Jones industrial average had plunged 173 points from a high in April. The skittishness at the stock exchanges stems from the same fears that plague the bond markets: traders and investors seem convinced that interest rates will not fall substantially anytime soon and that

Christoph Blumrich, Claire A. Nivola—NEWSWEEK

Reagan's combination of tax cuts, increased defense spending and tight monetary policy will make matters worse.

Sam I. Nakagama, chief economist for Kidder, Peabody, argues that—far from doubting the Administration's veracity—the markets are taking Reagan at his word. "They believe that there will be rising defense spending, that it will be difficult to make further cuts in non-defense spending and that we now have tax cuts that go on forever," he says. "That will all add up to deficits." If the Federal Reserve refuses to accommodate the deficit by expanding the U.S. money supply, the markets fear that Uncle Sam will soon be competing with all other borrowers for available funds, driving up interest rates once again.

Debate: Not everyone buys Wall Street's reasoning. Allen Sinai of DRI, for one, argues that big Federal deficits do not necessarily mean high interest rates. Historically, he says, interest rates have plummeted when the Federal deficit represented a big percentage of the gross national product and soared when the deficit was small by comparison. The reason is that a fat deficit as a per cent of GNP usually indicates a weakening economy in which private-sector credit demand is smaller. Conversely, a lower percentage figure indicates that the economy is expanding—and that private credit needs are fairly strong. Since the deficit for fiscal 1981 promises to be only about 2 per cent of GNP, Sinai argues that it is not at all surprising that interest rates are high.

But there is a much more important factor affecting interest levels—the inflation rate. Until the public is convinced that Reaganomics will succeed in bringing the inflation rate down, interest rates will almost certainly remain high—and the markets will remain in disarray.

In fact, many of the inflation-related signs are encouraging. During August the producer price index for finished goods, which measures wholesale prices for manufactured products, rose only 0.3 per cent, and in a three-month period ending in July average hourly wages increased at an annual rate of 6 per cent, down from 8.4 per cent for the preceding three months. At the same time the U.S. economy has not collapsed, despite sky-high rates and the devastation in the housing and auto industries. But the inflation rate, like other influences on American markets, is a creature of expectations, and some economists worry about the months ahead. "Any belief that the current period of sluggishness is simply a pause before a major rebound, rather than the beginning of a period of slow economic growth, could rekindle inflationary psychology,"

REAGAN RATES

In recent months real interest rates have moved to their highest levels in half a century. That, combined with Wall Street's skepticism about the Reagan economic program, has caused a long stock-market slide.

