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The American Economy: Is a Turning Point at Hand?

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Presentation to the Japan-U.S. Business Conference
New York City, July 10, 1989

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Historians tell us that every age is an age of uncertainty. The American economy in 1989 is an excellent example of that phenonemon. There are many reasons to believe that we are only going through the normal turn of the business cycle. But, then again, is the United States in the early stage of a longer-term and more challenging transformation?

In the economic sphere, the global village that Marshall McLuhan wrote about has not arrived. But the global marketplace surely is here. American businesses -- and consumers -- are making the adjustments to it both pleasant and difficult.

In the broader political sphere, the big question is whether the Cold War is ending. Will the United States -- and the Soviets -- successfully shift key technological, capital and labor resources to the civilian economy? Will the Marxist's view prevail or that of the supply siders? That is, will the lower military demand lead to worldwide recession or will it free up resources for stronger growth? In part, the debate on protectionism versus free trade will decide whether the outcome is positive or negative.

The Current Business Outlook

Let us examine the American economy today before turning to the longer-term but more fundamental issues. The recovery in the American economy has earned the respect that is generally accorded to old age. As someone who was present at the creation of the

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Reagan economic program, it is good to note that we are in the midst of the longest peacetime expansion in American history. But one of the requirements of old age is to think of the hereafter.

Despite the advances of modern econometrics bolstered by high-powered computers, economic forecasting still reminds me of the medieval soothsayer who depended on signs and portents to read the future. The signs seem to be pointing to the coming close of this economic expansion. In recent weeks, we have seen declines in a great variety of indicators -- ranging from the index of leading indicators itself to more specialized series on durable goods orders, machine tool orders, real corporate profits, auto sales, consumer spending, and monetary growth.

As a veteran forecaster with much scar tissue, I must admit that turning points are notoriously difficult to forecast. The next one is likely to be no exception. A variety of strong points keeps the recovery going. New business capital investment continues quite robust, especially while many industries operate with little excess capacity. The substantial expansion of U.S. exports reflects strong economies elsewhere as well as the delayed effects of earlier dollar depreciation. Modest inflationary pressure is an important positive factor. This gives the Federal Reserve System leeway in moving from restraint to stimulus.

Let me try to summarize the short-term economic outlook. In retrospect, 1988 was a better year than we expected. The economy grew a strong 4 percent and inflation a modest 3 percent. We will probably reverse that in 1989. The year as a whole will show more inflation -- close to 5 percent -- and also less growth -- likely around 2-1/2 percent.

Such a slowdown is often a prelude to recession. The odds are rising that a recession will be underway in 1990. Much will depend on actions by the Fed and the private sector which have not yet occurred. A word of caution is necessary. Contrary to the general view, economists are quite good at forecasting the year ahead. The prevailing yearly forecasts during the past decade were, on average, within one percentage point on real growth and also on inflation.

But economists are very poor in forecasting the next quarter of the year. Thus I have more confidence in saying that the U.S. economy may be in recession in 1990 than I have in forecasting the precise date of any turning point -- or even the quarter of the year in which it will occur.

The next recession -- whenever it comes -- should be mild. The Federal Reserve has considerable leeway. But policy problems are likely to arise. The outsized budget deficits will inhibit the adoption of stimulating fiscal policy. The downturn in the economy may coincide with long overdue budget cutting, especially in defense.

This would put the entire stabilization responsibility on monetary policy. At the same time, the business sector will be feeling the adverse effects of congressional microeconomic policy. The costs imposed by environmental and safety regulation will be turning upward. Congress has been legislating expensive new requirements for compliance in the private sector. This covers both old programs such as clean air and clean water and newer concerns, such as acid rain and global warming.

Simultaneously, business will be bearing the costs of the rising social mandates. This is a way in which Congress can bypass the budget process and avoid increasing fiscal deficits. Social mandates impose costs directly on business. Examples include a higher minimum wage, more liberal employee-leave policies, and compulsory contributions for health insurance and other fringe benefits.

Long-Term Economic Outlook

Let us now take a longer-run view of the economic environment. Looking out toward 21st Century, the United States is likely to be one of the three dominant clusters of economic power. The three will be the European Community, the Asian rim countries led by Japan, and the United States/Canada. In each case, I sense rising tension between the increasingly global nature of the modern business enterprise and the traditional, more limited territorial approach of government decision makers. For example, almost one-half of U.S. foreign trade is in the form of internal transfers between divisions of the same company. Also, about one-half of U.S. products contain some foreign component.

Consumers are ambivalent. They still often vote for legislators who want to "protect" their region from imports. But those same consumers increasingly buy goods and services produced all over the world. This leads me to a fundamental optimism about open markets prevailing -- in the long run.

I note that the USSR is conspicuously absent from my list of dominant economic powers. The USSR economy is in deep trouble. *Perestroika* is behind schedule. The Soviet economists frankly admit that there is less public support than they expected and far more obstacles than they had planned on. The Soviets very much want to become part of the global economy -- to join our international economic institutions -- IMF, World Bank, GATT, and OECD. This may be easier said than done.

The Russians love to cite old proverbs. In a recent meeting with Gorbachev's chief economist, I repeated an old American saying, "You can't put a square peg in a round hole." Their controlled economy needs to become much more open before the USSR can play a positive role in the modern global economy. For example, their current -- and very optimistic -- schedule for currency convertibility and pricing freedom extends deep into the 21st Century.

On balance, I find the ascendency of capitalistic institutions quite heartening. It is also a useful backdrop for considering the short-term economic problems facing the United States, such as the twin deficits in budget and trade.

The Policy Problems That Face Us

Let us turn to those budget deficits. In my judgment, there is much lacking in the discussions of the U.S. budget deficits on both sides of the Pacific Ocean. Many Americans blithely say we are outgrowing them. This ignores the intricate connections between our budget deficits and our trade deficits.

But I also find some of our friends in Japan assigning our budget deficits the entire blame for the massive trade imbalance between our two countries. Frankly, I find it as difficult to relate our bilateral trade deficit with Japan to our overall budget deficit as I find it to relate our bilateral trade surplus with Australia to our overall trade deficit. Clearly there are other factors involved -- and in both countries.

Thus I am led to underscore the need to proceed on both the fiscal- and trade-policy fronts simultaneously. In the United States, the bulk of our budget deficit arises from the rapid expansion of governmental consumption outlays. These essentially unproductive expenditures need to be curtailed substantially. That would improve the efficiency of our own economy. Otherwise, we will continue to see the budget deficits transform so much of our private saving into publicly-sponsored consumption.

Turning to Japan, it is good to note the substantial reduction in trade barriers that has occurred. But, as expressed by the Wisemen's Report a while ago, the Japanese economy is not yet as open as the American economy. In this regard, I am truly a consumer advocate. I do not hesitate to tell policymakers in the United States that reducing trade barriers will help our consumers enjoy higher living standards. But this bit of economic wisdom is not limited to this side of the Pacific. Further reducing trade barriers in Japan will help Japanese consumers enjoy higher living standards.

Aiming at more open trade is surely the constructive approach in adjusting the economies of both nations to the emerging global marketplace. But decision makers do not always follow economic advice. So I am led to a more ambivalent conclusion: Our economic fates are in our own hands. There is much that each of our nations needs to do. May each of us act wisely.