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THE ECONOMIC OUTLOOK

Moderator: JOHN M. BRAGG.
Panelists: DONALD RATAJCZAK*, FRANK A. CAPPIELLO, JR.**

MR. JOHN M. BRAGG: This is the sixth year in which the Society of Actuaries has held a special-purpose meeting. The topic of this year's meeting is "Economics and Financial Security".

Actuaries and economists are both in the forecasting business. We actuaries are lucky, however, because the truth of our forecasts really does not emerge until after our retirements. In the case of the economists, however, the truth is likely to emerge in a period as short as six months.

Our opening panelist is Dr. Donald Ratajczak. His economic forecasts have exhibited a very high batting average in recent years and are very greatly respected in the Atlanta financial community, as well as elsewhere.

DR. DONALD RATAJCZAK: This economic recovery is reaching its first birthday amid speculation that it will fail to return the economy to full employment anytime soon. Some economists project five years of recovery before unemployment significantly falls below 6%. Most business cycles are able to complete an entire boom-bust pattern in less time than recovery alone is projected to occur according to these economists.

Almost as many analysts expect the inflation-shortage problems to return by late 1977 and lead to another significant bust in 1978. For these people, if full employment is achieved at all, it will be only a fleeting period followed immediately by a contraction, possibly more severe than the 1974-75 recession.

Many businessmen apparently have extracted a bit of both projections in their plans. If 1974 is going to recur in 1978, companies want to procure long-term financing and avoid the prime rate escalator that proved so painful two years ago. Indeed, the rush to borrow funds at 8½% when 7% bank money is available has been unprecedented. This behavior not only reveals that business expects another rapid increase in short-term rates within the next few years but also suggests that the risks of facing sharply higher long-term rates (or being foreclosed from the market entirely) are felt more clearly than the benefits that can be derived from using bank credit until future credit market pressures can be seen more clearly.

Savings and loans also have been reluctant to convert their net additions of savings capital into mortgages outstanding. In 1975, savings capital grew by $31.3 billion while mortgages only increased by $20.5 billion. Yet downward pressures on mortgage rates were slow to develop, as associations apparently desired to place the funds into low-yielding liquid assets in-

*Dr. Ratajczak, not a member of the Society, is Director, Economic Forecasting Project, Georgia State University, Atlanta, Georgia.
**Mr. Cappiello, not a member of the Society, is President, Monumental Capital Management, Inc., Baltimore, Maryland.

stead of seeking the higher yields but longer term commitments in mortgages. They also were slow to lower the returns offered for long-term deposits. They apparently believed that the 7½% certificate deposit that currently is being used to purchase 6% commercial bank CD's certainly will be profitable over the four or six year life of the liability.

How great are these risks of escalating short-term rates, serious liquidity problems, and a possible new slump in the next few years?

It is apparent that many of the economic imbalances that created the last recession now have been corrected or are well on their way toward elimination.

First, the serious inventory imbalance, whose excess was historically high in terms of prevailing production and sales levels early in 1975, has been reduced to minor proportions. Indeed, Christmas sales were so unexpectedly strong that retailers now are restocking in order to raise inventories to desired levels. Only the metals and machinery industries still appear to have problems, and even these soon should be exhausted without production cutbacks because of an expanding economy. By the summer, production should attain a sustainable level of activity relative to sales.

Second, corporate liquidity problems are abating sharply. In 1974, corporate debt grew at a more rapid ratio relative to income than during any other postwar period. In the last four quarters, however, gross business savings actually have exceeded business investment by $3.6 billion. This situation tends to reduce debt. Inventory rebuilding is beginning to reverse these favorable conditions, but no early return to the previous burden of debt relative to income is in sight.

Third, the serious erosion in the ratio of household assets (including pension fund and life insurance reserves) to consumption has been restored partially. The combined effects of higher prices for consumption goods and lower market values for financial assets had reduced the aggregate household holdings of assets to only 1.5 years of current expenditures by the end of 1974. Abnormally high savings rates then were required to help re-establish desired relationships between current consumption and the purchasing power contained in financial assets. Together with rallies in the bond and stock markets, these higher savings have increased the purchasing power contained in household assets to more than 2 years of current consumption activity. This level is still below normal, which is 2.5 years of current consumption in the form of financial assets. However, the unusually high consumer savings rate that currently exists is more than adequate to restore the proper financial balances as long as financial markets do not slump and inflation does not flare up from current levels.

Several other problems have been reduced. State and local governments have ended the expansion of operating deficits and now should be able to increase expenditures or reduce taxes in proportion to growing receipts.

Excess inventories of unsold houses have been diminishing. Many "white elephants" remain, but the houses that are currently being sold were started less than four months ago. Also, savings flows into mortgage lending institutions currently are so strong that reduced mortgage rates, perhaps to 8¼%, may be required to restore balance between mortgages and total assets at these institutions.

Even the profitability of rental units has begun to improve. Because of rising construction costs and the sharp rise in utility prices, rental income actually retained by the landlord became increasingly inadequate to encourage construction of new apartments. The surge in energy prices now has abated, at least temporarily, while land and financing costs associated with multi-family construction have eased. These forces have raised a measure of rent profitability used by Georgia State University from 80 in the summer to 85 at present, but the index stood at 100 as recently as 1973. Under current conditions the economy should be able to support 440,000 multi-family units, a far cry from the 913,000 built in 1973, but more than the 250,000 started in this year's first quarter. Furthermore, current conditions are improving rapidly.

Thus, production relative to final sales, housing, and consumption, is destined to improve significantly in the next six to twelve months.

One source of uneasiness is the real or imagined capital shortages. At current rates of activity, private non-residential construction capital stocks are growing about 1.8% per year, or only about 75% of long-run rates of accumulation. Producers' durable equipment is being accumulated at an even slower rate of 1.5%, only about 40% of long-run rates of accumulation. Obviously, failure to increase these rates of accumulation ultimately will lead to capacity problems and severe inflationary pressures.

Some pessimists clearly are projecting these current accumulation rates forward and are concluding that renewed inflationary pressures soon will resurface.

Our own estimates suggest that even if full employment were attained, nonresidential construction would exceed needs by 3%. In this area of the economy a capital excess exists. The accumulation rate at only 75% of long-term rates is necessary to absorb this excess slowly. Even so, available capital will exceed full employment needs until the middle of 1977, and few expect full employment to be reached by that time.

Producers' durable equipment provides a different story. The recession was so sharp that utilization rates fell to postwar lows. This lowered the rate of accumulation so far below long-run rates that a continuation of these rates could lead to shortages in 1977, even before full employment is in sight. However, accumulations will not remain at these low levels. Already, durable goods' orders are beginning to increase. While utilization rates may remain sufficiently low to retard the expansion of investment activity until late in 1976, investment expenditures should be exhibiting healthy increases by that time. These developments will occur just as the current inventory restocking has been completed and permit further extension of the production recovery without causing a bunching of credit market pressures.

While even the pessimists usually concede that enough time remains to step up capital accumulation, they foresee conditions that make such increased investment unlikely. Some still persist in maintaining that the market system will not provide sufficient incentives to encourage capital accumulation until shortages again are upon us.

Some who have not yet given up on the effectiveness of incentives to remove shortages remain fearful that sharply rising interest rates will curtail investment incentives that otherwise would develop. Two variations of this "crowding out" scenario have been proposed, and both are worth exploring.

First, many are alarmed at the magnitude of government borrowings. In the last four quarters, debt held by the public increased by more than 20% -- a $77 billion addition to financial holdings. Of course, "wolf" was called early in 1975 when the federal deficit broke into triple digits. After a brief flurry of purchases by the Federal Reserve, interest rates resumed their downward path without further debt acquisitions by the monetary authorities. In short, the low level of capital utilization and the reduced return on capital restricted investment in 1975 -- not the borrowings of the government. Indeed, to the extent that government policy arrested the recession, leading to increased capital utilization, investment well may have been stimulated by government initiatives.

Because the "crowding out" wolf did not appear, some may conclude incorrectly that such an animal does not exist. However, the error in reasoning is caused by looking at the level of government borrowings and not its cause. Tax collections rise or fall with strength or weakness in the economy. In addition, some welfare and unemployment compensation disbursements rise as economic well-being declines. A recession, therefore, triggers increased transfer payments and reduced receipts. No additional goods are purchased, and no one is hired as a result of these deficits. These signs merely reflect economic weakness and, in that vein, coincide with reduced private demand for credit and weakening purchases of goods and services. Interest rates well could fall, as they did in 1975, and inflationary pressures should tend to diminish even as government borrowings increase. More than $50 billion of the government borrowings in 1975 were caused solely because of a weakening economy.

Problem-causing deficits are those which reflect increased government expenditures or reduced tax rates <u>for a given economic environment</u>. Even these deficits may be justified if investment incentives are being influenced more heavily by the utilization of equipment than by the cost of financing.

Unfortunately, government policy has not reflected an understanding of this point always. Sometimes politicians become impatient with the slowness of reducing unemployment. They tend to increase government programs even as investment is responding less to utilization and more to the cost of financing. At such a stage in the recovery, new government programs tighten credit markets and investment activity definitely is "crowded out". Unemployment may fall for a time, but the reduced growth in productive capacity leads to inflationary pressures, economic imbalances, and a new downturn.

The second version of "crowding out" of private investment occurs as a result of inflationary pressures and their influence upon credit markets. One variation of this argument is related strongly to government debt. The Federal Reserve can prevent a government deficit from exerting upward pressures upon interest rates for a short period of time by purchasing the bonds for its own portfolio. This action, however, increases the money stock and leads to increased expenditures. If production levels cannot be changed readily to meet these expenditures (or if producers prefer to meet unexpected changes in expenditures by price rather than production changes), inflationary pressures will intensify. The same degree of physical capital accumulation will require increased financing and will lead to increased credit market pressures.

Recent events have indicated that inflation also may be generated by economic shocks or by intensifying wage pressures in labor markets. One scenario is that wage demands will be so great in 1976 that a return to double-digit inflation is inevitable. In turn, credit market pressures will be created and lead ultimately to reduced investment and an economic decline. In fact, most analysts are extremely concerned at the high rate of inflation that persists following this largest postwar recession. If 5% is the inflationary floor, a return to double-digit inflation in the next expansion may not be an absurd expectation.

Everything may be possible, but an acceleration of inflation with unemployment well above normal rates and output levels significantly below capacity is not very likely.

Those who follow the hourly-earnings index are aware that hourly wages have been increasing at slightly over 7% annual rates in the last six months. While some contracts have been large, they have been more than offset by the minimal wage gains in many trade, finance, service, and goverment activities. A significant flare-up of inflationary pressures without fiscal and monetary encouragement is not very likely, and these policies are sowing the seeds of accelerating price pressures now.

Some policies could be better. Many Congressmen have learned their basic economics well but have failed to appreciate the assumptions required to make those economics understandable. For example, most beginning economics courses argue that a billion dollars of government expenditures on goods and services ultimately will put more people to work than a tax cut of equal magnitude. The basic reason for this conclusion is that purchases of goods and services create economic activity before purchasing power in the form of earnings is distributed. A tax reduction distributes the same purchasing power but does not generate that initial activity.

Unfortunately, our courses fail to emphasize that this conclusion assumes that both activities generate the same price and credit market pressures. In an inflationary environment, however, government expenditures, especially if they are concentrated in a few economic sectors, well may slow the price adjustment process, thereby prolonging inflationary pressures. Tax cuts that are not windfalls (e.g., not unexpected rebates) actually reduce costs or increase take-home pay. They directly lead to diminished price pressures. Once these differential effects upon price changes are considered, government expenditures may be inferior to tax cuts in providing jobs and are certainly less effective in reducing inflation.

I have criticized other economists. Now it is time to make my own assessments.

(1) Businessmen are too pessimistic in their assessment of credit market and inflationary pressures. Some acceleration of inflation well may develop in 1977, but it will be on the order of a ½ to 1 percentage point increase from an expected 5-6% rate in 1976. Substituting tax cuts for public works programs might lead to slightly declining inflation rates in 1977.

(2) Because of unjustified pessimism, the gap between long-term and short-term maturities is too wide. As this gap becomes apparent to more investors, bank credit will be extended and debt offerings will be slowed. A rally in newly-issued AAA rates to the 8% level seems justified even as short-terms begin to rise to narrow the gap. All rates are expected to move upward, but only gradually, in 1977.

(3) Inventory restocking will keep production growing above final demand in the first half of 1976. As final demand will be expanding by nearly 6% because of consumption and housing activity, production will be expanding by 7% over this period.

(4) Investment will begin to add significantly to final demand late in 1976, thus maintaining an expansion path near 7% even as inventory restocking comes to an end.

(5) Slower economic growth is projected for 1977, as savings rates cease their decline near 7% of disposable income, and housing activity approaches normal absorption levels of about 1.8 million units. However, strong growth in expenditures for capital goods should maintain the expansion at a 6% plus rate through much of the year.

(6) Policy will be especially critical late in 1977, as healthy credit markets will be needed to encourage capital expansion to return to normal rates of accumulation. Some good agricultural harvests, moderate wage demands, and reasonable pricing policies could lead to continued improvement in financial markets and strong consumption expenditures into 1978.

My best guess is that a durable recovery has commenced and that inflation and credit market pressures will not intensify. As financial markets are not fully expecting this outcome, significant improvement in the market value of financial assets remains probable. A return to double-digit inflation followed by an economic slump is possible, for some capital goods are in short supply if the economy moves too rapidly toward full employment. However, current policies are sufficient to avoid that outcome. Better economic policies are possible, and we hope that they will be tried.

MR. BRAGG: I am extremely happy to hear your belief that a durable recovery has commenced and that inflation and credit market pressures will not intensify.

Actuaries should be more closely involved with investment operations than they typically have been in the past. For the last ten years, I have been on the Finance Committee at Life of Georgia, the committee which actually makes investment decisions. The experience was tremendously valuable from a strictly actuarial viewpoint, in terms of my actuarial duties in making interest assumptions, statement decisions, etc. What happens to an actuary in this situation is that he learns a tremendous amount of valuable information from the professional people who devote their careers to investing funds. Our next panelist is actually in charge of the investment program of a major life insurance organization. He is Mr. Frank A. Cappiello, Jr.

MR. FRANK A. CAPPIELLO, JR.: My approach to the economic outlook will be from the standpoint of an institutional investor, as the chief investment advisor for two life insurance companies as well as outside clients, rather than from that of an economics forecaster.

We are medium sized in terms of asset management. The combined invested assets of Monumental Life and Volunteer State Life total about $640 million. We also have the responsibility of investing the combined annualized cash flow of about $55 to $60 million. Adding outside clients to this list, which includes pension funds, profit sharing plans, as well as charitable foundations and large individual accounts, would raise the total by about $24 million. Additionally, our holding company, Monumental Corporation, has a large investment real estate complex which develops and operates shopping centers, garden apartments, and office buildings throughout the eastern sector of the United States and in Dallas and Houston.

From this orientation, our view can be summed up as positive for the next 18 months. We see a continuation of the gradual economic recovery we have been witnessing and the key word is gradual. In addition to the short-term optimism, we have some longer term concerns. There are basically four: energy or the lack thereof, certain aspects of the international monetary situation, the Federal deficit, and, finally, the future of political democracy in the United States in the economic framework of continually rising expectations on the part of the electorate.

For the short-term prediction, we have to realize where we have been in terms of our national economy in order to have the perspective and the confidence relating to the future.

Looking back over the past 18 months, one can see the economic wreckage of the worst recession since World War II in terms of duration and severity. This recession has deeply scarred a number of important industries, including many of our financial institutions, and left a legacy of caution that will not be dissipated quickly. While there is still debate as to when the recession officially ended, most economists place it around April or May of 1975-- during the period the Federal Reserve Board's Index of industrial output struck bottom, along with an assortment of other closely watched indices. From that point, the economic recovery has been slow and steady but greeted with apprehension and skepticism. There has been fear of a recovery that was too fast and would result in a resurgence of inflation. This fear has been mollified as we have seen continuing evidence of an unwinding of inflationary pressures. It is now conceded that the slower the recovery, the better. A slow recovery means less upward pressure on interest rates with fewer dislocations all around.

My central theme of optimism relates to this slow recovery because it takes time to repair the damage done our banking system, particularly in the real estate area. While corporate liquidity is improving gradually, the biggest reason for expecting a slow recovery is that a significant amount of debt in far too many corporations and substantial amounts of low grade or marginal loans in far too many banks still remain. It takes time to work off these problem loans and also to regain the confidence of another major segment of our economy -- the consumer. The consumer was traumatized by high inflation beginning in 1973, and the consumer reacted in predictable fashion by curbing his major purchases, a common trait in periods of high uncertainty, and increasing his savings. He and she were ravaged by spiraling food prices, higher prices for energy including gasoline and utility bills, high interest rates, and increasing state and local taxes. The cure, the restoration of confidence, takes time and is a compound of diminishing inflation and the consumer's perception of that diminishment and gradually improving wages.

Finally, capital spending, another prop to a recovering economy, will be at a low rate during the first half of 1976. Businessmen do not add to plant when operating with substantially unused capacity. In fact, they do not add to plant until they are well beyond 85% of operating capacity and heading toward 90% with rising sales at the retail level. This situation will not develop in some industries until well into the second half of 1976 and possibly early 1977.

The picture then is one of a slow restoration of health to most segments of the economy but one that is gradual enough not to put inordinate strains on our capacities, both financial and human. The unemployment rate, while down from peak levels, is still at a historically high level. In sum, slow is good; fast is bad.

Our overall view of economic activity for 1976 in terms of some key summary numbers is as follows:

Real GNP: an increase of about 5%

Unemployment: 8% down to 7% by yearend

Corporate Profits: up 25%

Inflation (CPI): average probably about 6%, could be 5%

State and Local Spending: up 8% in 1976 (versus 10% increase in 1975 and 13% increase in 1974)

Federal Spending: up 8% in 1976 (as opposed to 22% in 1975 and 13% in 1974)

Federal Deficit: about $50-$60 billion in fiscal 1977; total spending by Federal Government expected to be $401 billion

Interest Rates:

Long Term: high quality AAA industrial in a range of 7½%-8½%

Short Term: as measured by the Prime Rate:

Second Quarter 1976 - 7 3/4%
Third Quarter 1976 - 8 1/4%
Fourth Quarter 1976 - 8 1/2% - 8 3/4%

Housing: an estimated 1.7 million units (1.2 million single-family and .5 million multi-family)

Capital Goods: capital expenditures in 1976 basically flat but 1977 could be a good year

Essential to a rebuilding of both corporate and individual liquidity is a predominant drive to increase savings and to reduce indebtedness. This drive is a natural result of the financial crises many individuals and corporations went through during the inflation and recessionary period of the past two years. This caution or timidity is the basis for our projection that long-term rates will probably decline on average through 1976 and probably into the first part of 1977. Most specifically, long-term rates should be in a downward drift following along the lines of lowered inflationary expectations and the absence of a substantial amount of corporate and municipal demand for long-term financing.

While the Federal Government will be a factor from time to time, we do not perceive any "crowding out".

The long-term danger of our increasing governmental debt burden, both on a state and municipal level, is witnessed by the continuing problems of New York City, New York State, and Massachusetts. The painful financial problems of our states and municipalities will continue.

There is also concern for our national debt level, which has an average maturity of 30 months, most of it short-term and likely to go shorter. Rollover of this debt is likely to put upward pressure on short rates. However, the fiscal problems of our governments are longer term problems, a signal for caution but not for current pessimism in viewing our securities markets.

There is a pessimistic minority view of prospects both for our economy and securities markets: gradual recovery in business in 1976 followed by a recession in 1977 and a resurgence of inflation.

This scenario includes short-term rates as high as 15% and a new round of double-digit inflation during the latter part of 1977. This is the old "boom and bust" scenario which some economists began to fear in the summer of 1975 when they saw what seemed to be too rapid a rebound in the economy. Among the more vocal members of the pessimist school is Michael Evans of Chase Econometrics, although even he has tempered his pessimism somewhat. Arnold Moskowitz, economist for Dean Witter and Company, also predicts a similar economic scenario: a recession coupled with an inflationary spiral. This is a rerun of the 1973-1974 inflationary spiral beginning in 1978. Part of this pessimism relates to the possibility of unleashing a new price spiral through heavier Federal spending since this is a political year, and politics during this period usually transcends economics.

This scenario would require much bad luck in our economy and mismanagement on the part of the Federal Reserve, Congress, and the consumer. Too often we are prisoners of the past, and it is tempting to extrapolate the past into the future. In reality, the future is being made right now on the base of what had been happening over the past ten months. Most of the fundamental economic news continues to be positive for the economy and the stock market. The broadest monthly economic statistic for the market is economic production, and that has been rising steadily since early last year. Consumer spending has been rising and will continue to rise, maintaining the momentum of recovery. Later this year, housing will begin to support the economy, providing continued momentum into 1977. The year 1977 should be a good one for capital spending. All in all, the economic scenario is pleasant and profitable.

For the long term, we have four concerns, as earlier noted. The first, and most important one really, relates to our energy policy or, more properly, our lack of energy policy. Interest and focus on solutions that were talked about in 1974 and 1975 have dissipated. In effect, the United States is worse off today than in 1973. There is no quick and easy answer to our increasing dependence on imported oil. We continue to be hostage to both supply and price. The energy crisis is still very much with us, like a "ticking time bomb". There is no question, statistically, that the United States production of energy is dropping. At the same time, our needs are increasing, and imports are the current answer. We continue to be at the mercy of OPEC and vulnerable to sudden increases in the price of oil or to any future embargo.

Why, after the shock of the oil embargo of the past several years have we allowed ourselves to get into such a position? There are a number of reasons, but two seem to stand out:

(1) We have played politics with oil and have attempted to maintain a duality of price, which is really a fiction and will serve to diminish the incentive to exploit some of our higher cost fuel reserves in the long run.

(2) Our environmental and pollution advocates have been overzealous. They have prevented the expansion of nuclear reactors, offshore drilling, and the fuller development of our coal lands. Environmental concerns are laudable but will be very expensive for us as a nation in the long run. Each year's delay results in increasing costs.

A good example of the difficulties in exploiting that often-quoted "500 year reserve of coal" can be seen in a town called Hazen, North Dakota. Here, farmers and conservationists in Mercer County, North Dakota, have lined up against a Detroit-based utility (American Natural Gas) that seeks to build the first commercial coal gasification plant in the lignite-rich western coal fields. The proposed site is nine miles west of Hazen. (Coal gasification is a complex process by which coal is turned into a natural gas substitute.)

Resistance groups are attempting to prevent the Company from building a $1.5 billion gasification plant which would cover about 1500 acres of pasture land. Most of the gas produced would be piped to Michigan and Wisconsin. The size of the project disturbs most people in Mercer County, particularly since the Company is suggesting that eventually it would like to build twenty such plants across the western North Dakota coal belt.

There are some 250 to 300 billion tons of recoverable coal under the thirteen western counties of the state alone. So far North Dakota has taken a "go slow" attitude about the development of its coal. The plusses to Mercer County are an increase in tax base and in general economic wealth. The population of 6500 could more than double in the next three years. However, continued delays may result in nothing ever being built to exploit these coal lands.

Further, energy research is lagging primarily because we have no coordinated energy policy. Oil shale now appears to be hopelessly out of the race from the standpoint of cost. Geothermal policy is only a modest stop-gap at best. Gas from coal is feasible but probably not possible under the current conditions. Finally, solar energy still awaits a breakthrough in the efficiency of energy conversion.

Therefore, the one continuing long-term danger for the economy and for the stock market is our inability to come up with a coherent energy policy. Perhaps we might get political leadership once the 1976 elections are out of the way.

Later on in this decade OPEC could break in the face of an excess of oil if substantial new fields are discovered. Unfortunately, most of the new major finds have not been in politically secure areas. For example, a recent major new find was disclosed by the American Arabian Oil Company: the discovery of three new fields with proven reserves totaling more than seven million barrels. Unfortunately, all are located in Saudi Arabia.

Our "drifting" energy crisis is the only real substantial negative. All other problems are solvable and are, in fact, in the process of being solved. Even energy in time will yield to a "workable" solution.

A second major long-term concern relates to international problems, mainly economic but in part political. We will always have painful political problems in the world that could erupt, from irritations to mini-wars and possible confrontation of major powers. The Middle East and, specifically, Lebanon, where a nation is dissolving into chaos, appears to be the current critical danger area. The apprehension here is a preemptive strike from Israel or the Syrians which could upset the delicate balance in that area. Any movement to fill the current power vacuum in Lebanon could ignite into conflict. As always, the Middle East continues to be one area of confrontation by the United States and the Soviet Union. Another potential confrontation area, and one that is sadly deteriorating, is South Africa and, specifically, Rhodesia and its relationship with its neighbors. Although one can make only a crude assessment in this tangled area of emotions and conflicting national objectives, no conflict is expected in these areas which will create an international crisis. However, one makes these judgments on a continuing basis, week to week.

Another part of the international problem is economic. In the past, recovery in the United States inevitably led to a recovery in Western Europe and Japan. The usual time lag was six to nine months. This connection no longer appears to be true. Recovery seems to be stalled in these countries. High inflation and unemployment are compounding the problem. There is a dilemma in that too fast a recovery could mean more inflation superimposed on an already intolerable rate. There is an additional burden of rising deficits. Yet, too slow a recovery means continued high unemployment and political risks. The temptation and easy way out has been to devalue and stimulate export markets. We have witnessed a series of bizarre monetary moves. Italy and Britain, the two sickest nations, have allowed their currencies to sink to new lows. The French have, in effect, devalued the franc. These competitive devaluations are disturbing and they could be the beginning of a destructive trade war with the ultimate contraction in world trade. Finally, the United States and West Germany appear to be getting stronger on a relative basis but at what risk? This international monetary area is one for continuous monitoring on a long-term basis. Nothing ahead in the short-term should cause any significant problems.

The third long-term concern relates to the large Federal deficits, which will continue in 1977 and probably in 1978. As we move into 1977, the Federal deficit will be much smaller than those registered in the past several years. The deficit in 1977 will be on the order of $50-$60 billion, lower than the peak but still high by any historical standard. We will be in the curious situation of large Federal deficits in tandem with a strong economy and an inflation rate high relative to prior recession recoveries. These large Federal deficits cannot continue without severe operating problems on the part of the Treasury and with considerable effect on the national economy. The major economic issue in post-election 1977 will be how to reduce the deficits. There appear to be three options, and they are unpalatable: higher taxes, reduced spending, (or a combination of the two) and, finally, wage and price controls. The approach taken will depend on which politicians will be required to resolve the problem in 1977, the type of new Administration that will be taking over in January, 1977, and the composition of Congress.

Perhaps the easiest course would be to ignore the deficit and rely on wage/price controls to suppress the demand-type inflation that our economy will face in 1977. The history of the effectiveness of wage/price controls does not give us much hope for this type of a solution. Another approach would be to maintain present spending levels and raise taxes. A third alternative is the reverse: to maintain the present tax rates and to reduce spending. A variant would be to reduce both spending and taxes.

The Federal Reserve will play an important role in any solution since it is mandated to continue to encourage a mild upswing and yet be wary of any rise in inflationary expectations. In this respect, the Federal Reserve will be "walking a tight rope". A sudden increase in interest rates could result in choking off the economic recovery, and a decrease in interest rates could encourage businessmen to speculate on easy credit. The best of all solutions and probably the one most saleable to the electorate would be to hold down spending in some ways and maintain present tax rates. The danger is that the Federal Reserve may be forced into some sort of restraint in 1977 in order to dampen rising inflationary expectations, and this restraint could be in a recovery still incomplete. A tightening of money supply at this point could produce suffering in certain sectors of the economy.

Our debt structure on a national basis, our level of spending, and the increasing demand by voters for additional services from the Federal Government have created a fiscal problem which could well be a nightmare in the years ahead.

My final long-term concern can be described as a concern for the future of a political democracy in a situation where the electorate has continually rising expectations. More and more people want increasing shares of the "goodies" in a situation where the "goodies" bag is not increasing at all. The current attitude toward oil companies in the Congress is really one manifestation of the entire turning-off process that the public and particularly the voter has gone through as he or she views private enterprise. The voter has been told since childhood that America is a great and wealthy country, the greatest and richest country in the world. Against this kind of Pavlovian conditioning, it is easy for young and middle-aged adults to become increasingly frustrated when they cannot get their share, meaning not only additional highways and dredged rivers but also soft services such as health care and welfare. The process of seeking to fulfill expectations requires recurrent attempts to stimulate the economy, both fiscally and monetarily. This stimulus produces waves of inflation which in turn are financed by wider deficits. No politician wants to say "no". He knows that his opponent who is trying to get his congressional or senatorial seat will promise the voters anything to get in. The incumbent is left in a weakened position to say "no". From time to time, leaders appear on the horizon that appear to offer some hope to this endless round of more and more from the Federal Government. Governor Brown of California may be a symbol of this trend. At least he has been publicly successful in telling his constituency that if they want additional "goodies" they have to pay for them. The brightest ray of hope may be a renaissance of political honesty with the voters.

In any event, on a short-term basis, we are optimistic and on a longer term basis, we must have faith in the system, which has not failed us yet.

MR. BRAGG: Your comments, delivered from the viewpoint of an investment officer in the life insurance business, are very valuable and meaningful.

For the last few years, we have been in an entirely new investment ball game. Apparent yields have been high, but there is no doubt that problems have emerged and that more will emerge. Ten years ago, we would not have foreseen the things that are now happening, such as the W. T. Grant's, the Penn Central's, and the defaulting commercial mortgages. Actuaries cannot ignore such developments. In many companies, arguments probably are going on regarding the percentage of available funds which should be placed in fixed-income securities. In many companies, special investment reserves probably are being set up or considered. GAAP statements do not recognize the Mandatory Security Valuation Reserve. Furthermore, even in the statutory statement, that reserve does not contain any component for mortgages and real estate. Companies should be setting up special investment reserves for mortgages and real estate in both statutory and GAAP statements. Companies should be setting up special investment reserves in GAAP statements for bonds, as well. The determination of such reserves is a pseudo-actuarial matter, which is based on the probability of loss.

(Questions and Answers following Panel Presentation)

1. Pension actuaries tend to assume that a given amount of inflation produces a "one-to-one" increase in both (a) rates of investment return, and (b) rates of salary/wages increase, i.e. 2% inflation increases both interest rates and wage rates by 2%. Is this (a) realistic, (b) simplistic?

   DR. RATAJCZAK: In the long-run, inflation will tend to raise interest rates and wage rates by the same percentage points. To this extent, the one-to-one assumption, while simplistic, is justified.

   However, inflation could have significantly different effects upon wages and the return on capital in the short-run. In the 1960's, productivity was unusually good. As a result, inflation and interest rates were lower than normally would have occurred for a given rate of wage growth. However, factors such as oil price changes have drastically reduced the return on capital. For example, we are now using \$7 - \$9 of capital expenditures to obtain a barrel of oil where \$.25 would have sufficed three years ago. This has significantly reduced the productivity of capital and overall productivity growth.

   At the same time, rapid price increases have sharply increased wage demands and inflationary pressures. As a result, more inflation is being generated from a given rate of wage increase than previously occurred. Those who assume the mid-60's established the appropriate relationship between wages and interest rates for the then prevailing inflation rate will discover that a simple inflation add-on no longer holds. Thus, the real wage/interest rate differential in the early 1970's, which is about one percentage point higher, is probably more realistic.

2. What is the long-run prognosis of inflation and interest rates?

   DR. RATAJCZAK: Long run is easier than short run because it excludes the cyclical fluctuations around a long-run trend. It seems inflation is on a 5-6% long-run track. Wage costs are expected to rise by 8% while return on investment is between 8 and 9%.

3. The comment was made that double-digit inflation was an "accident" and probably will not occur again in the next decade. Is this forecast subject to no "accident" occurring again or is the forecast that there will probably be no "accident" occurring in the next decade?

MR. CAPPIELLO: The double-digit inflation was not just an accident. It was a series of coincident events. International banks and the Federal Reserve were pumping money into the system in 1966 and 1967 for a number of reasons. At the same time, the Vietnam war was diverting capital into what could be termed non-economic employment. Additionally, wage and price controls were pulled off about two weeks before agricultural prices began to explode literally. The crowning blow since 1966 was OPEC, which led to quadrupling oil prices. The result of all of these factors was inflation.

Although oil prices will drift up, they should not double. We are not likely to have similar growth in the money supply coincidentally in Western Europe as well as in the United States. Two devaluations of the dollar, which had enormous implications on our exports and imports, contributed to our situation of inflation. All of these things are unlikely to happen again. However, our problem over the next couple of years may be deflation rather than inflation. That is, we are likely to have deflation in many sectors of the economy which will influence overall outlook for price levels. Real estate today in parts of Florida is as bad as it was in the 1930's and will take a while for recovery. No one expects the price of gold will go to $200 any time soon. Copper, grain prices, and even soybeans, because of palm oil substituted, may need support. The stock market has already experienced a deflation, down roughly 50%. The banks are not going to feel an expansion in the next couple of years, because of recent scares. The Federal Reserve certainly is not going to feel the expansion.

Therefore, there can be optimism that in the balance of this decade, inflation will gradually unwind in the United States. In some instances, the diminishing rates may be absolutely shocking. The fact that no one is thinking in these terms lends credence to its probable occurrence.

4. How does investment policy differ for pension and insurance funds?

MR. CAPPIELLO: Basically there are many similarities. They both require long-term investments. They both have substantial and persistent cash flows which can be calculated. In investing for a life insurance entity, cash flows can be estimated on a combined basis going up to 1982 or 1985, within some minor variation. Substantial investment advantages are obtained through persistent cash flow. Pension funds have the same dynamic cash capabilities.

The differences relate to the tax situation. For many companies, the tax situation has been climbing gradually over a period of time. Investments are made with consideration for the tax relationship. High-yield common stocks may offer very substantial benefits because of the taxable situation. For a pension fund, on the other hand, real estate may be a growing and more important segment that should be considered.

5. What level of large union wage settlements (e.g.,Teamsters) in the upcoming year is needed to avoid a serious disruption of the current economic forecast?

   DR. RATAJCZAK: The media focuses on large contracts, but wage costs depend on the impact of all wage relationships. Normally, 2/3 of all contracts are providing benefits in the second or third year of their existence. Typically, these wage gains are less than in the first year of the contract. Some non-union relationships are in tandem with union wage gains, but nearly 3/4 of the work force is not subject to long-term contractual relationships. For example, the contracts negotiated in the first quarter of 1976 provided for 8.8% first-year wage increases. However, the hourly earnings index, which reflects these other factors as well, grew less than 7% at annual rates.

   If the Teamsters come in with less than 10% per year (as they did), the 5-6% inflation forecast will not be upset this year. In the unlikely event that contracts can be written in the 7% to 8% range, long-run inflationary pressures could be reduced by 1% to 2%.

6. Some observers are concerned that the severe losses suffered by United States banks in the past two years are such that the banking system now does not have the financial strength to meet consumer and business loan demands, thereby undermining the expected economic expansion. How valid is this concern, i.e. that the expansion will abort because of the weakness of the banking system?

   MR. CAPPIELLO: The banks invested too freely in R.E.I.T.'s with the aim of getting leverage into profits and in getting profits up. However, the worst is over, although there may be a few more failures. The weakness of the banking system is really a positive sign. Bankers now have become very cautious, which is good. In banking statements, maximum contributions are now going to the reserves and to the bad debt reserves. In many instances, these contributions are in excess of what will actually be charged this year.

   For the future, banking liquidity should improve. Many of the regional banks should become stellar performers this year in terms of price levels. Banks in New York City may require a cautious view because they are hostage now to the state banking system and to the state. Also, banks which have considerable investment in undeveloped or lesser-developed countries would have difficulty foreclosing.

   DR. RATAJCZAK: There is room for concern that banks have not learned their lessons adequately. In the early 1970's, real estate was believed to be the best investment. However, any advantages that an investment has should be bid away, as new investors are required to pay more to acquire it. Banks now appear to be moving heavily into consumer loans and may yet place too heavy a reliance on these loans.

   This shift in portfolio behavior is affecting the recovery of various segments of the economy, e.g., consumer expenditures are leading and multifamily construction is lagging. However, bank activity is not retarding appreciably the overall recovery.

Actually, conditions in the banking system are better than current figures show. The return on new investments is good. In effect, the banks' true balance sheets are improving, but not all the adverse effects of previous investments have been acknowledged. Some poor statistics still may be recorded, but few bank failures are expected in the next few years.