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THE NORTH AMERICAN ECONOMY IN THE 1980's, OR "THE FIRE NEXT TIME?"

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MR. ARDIAN C. GILL: We have the good fortune this morning to hear from two well known economists on a very important topic — survival. Can we survive another high interest rate crunch, especially if it lasts longer than the last one? Our savings institutions, whether they are direct savings, pension funds or life insurance, thrive on stability. We are faced with instability in the form of high interest rates, loss of investor confidence, high inflation rates, changing expectations, and, at least in the U.S., a very cumbersome response mechanism in the form of regulation by 50 state legislatures. It is a system designed for more stable times.

It seems appropriate to start with the representative of our host country, Mr. Robert R. DeCotret. He is a graduate of the University of Ottawa with a degree in economics and he has advanced degrees from McGill and the University of Michigan. He was a senior staff economist on the U.S. President's Council of Economic Advisors. He was Advisor on Monetary Affairs in the Department of Finance in Ottawa. He has held various positions in the Conference Board in Canada, including the position of President. He was elected to the House of Commons in October 1978 and called to the Senate of Canada in 1979. In the Clark government, he was appointed Minister of Economic Development, Minister of Industry, Trade and Commerce, and Minister in Charge of the Northern Pipeline Agency. He was the Chairman of a cabinet committee of economic development. Since June of this year, he has been Senior Vice President and General Manager of the National Bank of Canada.

MR. ROBERT R. DE COTRET: It is a pleasure to be here today to talk about the Canadian Economy. When we look at the decade we are entering, there is much cheerful pessimism. Some people expect to have a major crash in 1985; some people expect the system to collapse totally before the end of the decade; and the optimist feels that we are going to live through a very difficult period with high interest rates, high inflation rates, high unemployment rates, low profits and low whatever else is good. I thought that this morning I would talk about the current state of the Canadian economy, because that, certainly in Canada, explains some of the gloom and doom that prevails at the moment. I would like to spend time on some of the problems or challenges facing Canada in the decade of the 1980's and then make some concluding remarks about what general direction the Canadian economy and financial markets in particular are likely to take over the next ten years.

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There are some very real parallels in Canada with the situation that you are witnessing in the U.S. We are in a clear cut recession. Our GNP this year will fall by about half a percentage point. Our unemployment rate is intolerably high, roughly 8%. Our corporate profits will show a growth of only 5%. Finally, we are back to double digit inflation; for the year as a whole it will be in the neighborhood of 10%. This recession has one thing in common with all of our post-war recessions -- the Canadian economy is moving very much in tune with the U.S. economy. Whether that is good or bad depends on your point of view, but certainly here, as in your country, the recession is likely to be the worst in the last 20 years.

However, there are certain interesting characteristics -- particularly when we compare this recession in Canada with the 1974-1975 recession. At that point, Canadian domestic policy was clearly designed to avoid the effects of the U.S. recession. In the Fall of 1974 we had a very stimulative fiscal stance introduced in the budget. There were tax cuts both on the personal side and on the corporate side. There were expenditure increases. Monetary stimulus led to a nominal decline in interest rates, and even led to real rates which turned negative in late 1975. We had inventory accumulations that definitely hampered the downswing in the Canadian economy. We had strong increases in wage rates and, as a result, personal consumption stayed alive. All told, the recession at that point was mild; we did avoid the severity of the U.S. recession despite a sharp deterioration in trade.

When we look at the current recession, we find a very different scenario. There has been continued policy restraint on the fiscal side in the federal budget, on account of the very large deficit. There has also been restraint on the monetary side, led on the one hand by the continued concern over inflation and on the other hand by the continued weakness of the Canadian dollar. There has not been the kind of inventory accumulation that we witnessed in 1974-1975 and, as a result, we have not had that buffer. We have not had real wage gains and, as a result, consumption has been flat. We have had a major readjustment in the housing market. Despite the fact that we have had somewhat better trade because of the weaker import demand, we have had deterioration in our trade position and, as a result, the worst recession since 1954.

A second interesting characteristic of this recession is the very wide divergence in its impact between regions and industries. The western provinces are not feeling the recession at all; their economy is booming There has been a very significant recession in Ontario and in the Maritimes, while in the province of Quebec, the performance of the economy over the last 12 months has definitely been above that of the average Canadian economy. So the recession is certainly not uniform through the country, nor is it uniform across our industries. Obviously the consumer goods industries, particularly durables and particularly automobiles as in the U.S., have been hardest hit. Our housing industry has been very hard hit, as well as industries that depend directly on government spending.

A third phenomena, one that you are also witnessing in the U.S., is the possibility of a roller coaster effect. We might emerge briefly from this period of economic stagnation, enjoy a few good months, and fall right back into recession, to come out again only in late 1981. The similarity between our two countries is quite striking. Looking at the leading indicators in the U.S. in the last two or three months, things seem to be improving quite significantly. Looking at those indicators for Canada, the numbers I'll

quote are month-to-month changes not annualized numbers, our retail sales increased by 3.5%, wholesale trade by 8.8%, and manufacturing new orders by by 9%. Order books are 2.3% higher than last month and our inventories are falling. Our exports increased by 5.1% and our imports decreased by 6.1% for a massive swing in our balance of trade. So one could look at these indicators and conclude that the recession is over and things will improve. I believe things will improve but I do not believe the recession is over. Some of the basic adjustments that we are undertaking in the economy during 1980, both in Canada and the U.S., still have their course to run. While we may see a significant and sharp improvement for a few months in the fall of 1980, the recession will continue into the early months of 1981 and only towards the middle of that year will we see the reversal of the recession. All told then, there is some light at the end of the tunnel. There will be a slow recovery because of a difficult adjustment process that will extend to the mid 1980's. But, by international standards, if we compare Canada to the other countries of the OECD, there is an encouraging outlook for the decade as a whole.

I would like to turn and deal with some of the critical issues, whose resolution or lack of resolution will influence the course of our economy in this country for the better part of the next ten years. Don't be surprised if you find some similarity in some of these issues with some of the policy dilemmas that you are facing in the United States. I would like to talk first on the constitutional issue. Even though some people might find it strange, the constitutional issue does have a very real bearing on how this economy performs over the next decade. Before I continue, I would like to emphasize that the constitutional issue does not in any way put in question the political stability of this country. It is more an exercise in fine tuning than stability. How then is the constitutional issue infringing on the economic outlook of the decade? First of all, the major impact that we have witnessed to date is that of the uncertainty this issue breathes. I need not go back too far in history to remind you of the difficult period we lived through in this country and this province with the referendum of last May. That certainly generated considerable uncertainty in the business community. We also have had continued uncertainty throughout the summer months while constitutional talks were underway. Now, we have a package of proposals on the table which are certainly leading to widespread debate in this country and once again creating a significant amount of uncertainty. One of the other impacts of the constitutional debate is that it has been the unique focus of policy in such a way that attention has not been directed at other major issues that required urgent attention. Finally, when we look at one of the core elements in constitutional reform, the distribution of powers, who is going to be responsible for what? What is the Federal Government going to be allowed to do? What are the provinces going to be responsible for? How are the taxing powers going to be divided? That part of the debate has led to some significant delays in certain major projects across this country, for example, some of our key energy projects. However, on the positive side, the constitutional debate is now at a stage which begs resolution and which will see some form of resolution over the coming years.

The second issue which I would like to touch on briefly is the energy issue. This is not a problem. It is a great potential; it is a great challenge and it will be the dominant feature of economic development in this country in the decade of the 80's. What is the energy situation in Canada? We have all the energy resources that we need as a country. We have oil, natural gas,

hydroelectricity, coal, and other forms of nonconventional energy. We can, and we must, as a nation become self-sufficient in energy. The potential is there. Now, what are the handicaps? First of all, the current level of supply and the current level of supply development is insufficient for us to attain the goal of self-sufficiency in this decade. The first priority is one of increasing supply. The second priority is one of lowering consumption growth of energy per capita. We in this country consume more energy per capita then any other country in the world. Even if an adjustment is made for the Canadian weather, and even if an adjustment is made for the distances that we have to travel to move goods, services and people in Canada, the consumption of energy per capita in this country is still the highest in the world. That is certainly not an enviable record in this energy short world that we live in. Finally, we do not have the distribution network to move western energy to eastern markets. Obviously if we want to become self-sufficient, that is an element that will have to be resolved in the very near future. Well, these three priorities of increasing supply, lowering consumption and improving our distribution network all boil down to one simple thing -- money. In Canada, our energy prices are about half of those of the rest of the world. There is no alternative in the 1980's but for the Canadian price of crude to move gradually up to higher levels. And I am choosing my words carefully because I want to avoid using the word world price. We became involved in a discussion about world prices at the time we envisaged the development of our nonconventional sources of supply. The price required to develop those resources was equivalent at that time to the world price. That is not necessarily true any longer and will not necessarily be true over the long run. What we need in this country is a domestic price for crude that is sufficient to encourage the development of our new sources of supply.

My third issue, the management of the public sector, is a problem of deficits. We have two big deficits that are increasingly creating policy dilemmas. We have a large Federal Government deficit that is likely to reach close to 15 billion dollars this year and we also have a large current account deficit in our balance of payments. The deficit in our balance of payments is unusual because while we have a fairly comfortable surplus on our merchandise account, there is a large deficit on our service account, not the least of which is the service charges on our foreign debt. Well, what are the implications of those two deficits? The first implication is that it reduces the ability of the private sector to finance cash requirements. The government requires very sizable amounts of finances every year. If we are going to be able to meet the very large cash requirements through our financial markets, the government is going to have to lower spending, and lower deficits. Just to give you a brief idea, in energy alone, we expect that our investment requirements will exceed 300 billion dollars in the decade of the 1980's. That does not include any estimates for the investments that are going to be required in our export oriented industries, our import replacement oriented industries, and our high technology industries. These are all industries that have significant investment requirements for new capital over the next 10 years. The second implication of these two deficits is that it reduces to a very large extent the flexibility of government in the field of economic policy. In terms of fiscal policy, with a deficit of close to 15 billion dollars, there is very little room for stimulative action. As a matter of fact, stimulative action, if undertaken with that kind of deficit, could be counterproductive. It could have a very significant negative impact on confidence. Monetary policy is increasingly dictated by foreign market developments because of our large reliance on those markets to finance

our capital requirements. It is limited by the current account deficit, by the investment requirements, by inflation and by the value of the dollar so that there is very little room to maneuver in terms of new initiatives. And finally, the situation of the two large deficits will force a fundamental reevaluation of our attitudes and of our policies toward foreign investment. Attitudes and policies in the foreign investment field in the last decade have led to an increasing debt burden and enormous pressure on the merchandise trade account to try to overcome that debt burden. When we look at the forecast for the next ten years, it is unrealistic to expect that our merchandise account will be able to do the job. We will have to change our approach to foreign investment or our debt burden in this country will become very difficult to carry.

A fourth issue is that of inflation. Inflation in Canada will continue at fairly high rates. It will do so for two basic reasons. The first reason is that we have not, as you have partially and as other countries have totally, adjusted to the new realities of energy world pricing. As I mentioned earlier, we will have to do that over the next four or five years and that will result inevitably in continued upward pressure on consumer prices. Secondly, I firmly believe that the system has a diminishing ability to adjust. The inflation situation that we are living through today is very much an income distribution problem. If you care to look back in both our countries to the late 1960's and the 1970's, we find that there was a significant shift of real resources in favor of those less privileged in our industrialized societies. There was a marked shift in real resources in favor of the agricultural sectors in our societies and in favor of the oil producing countries of the world. Everybody was quite pleased and happy to find that we were taking better care of the underprivileged, the sick, the poor, and the blind. Everybody was quite happy to see the farmers improve their lot. Most of us were happy to see that the oil producing countries were able to get a real return on their basic resource that would allow them to develop their economies. That is, up until the point where the industrial worker in our societies found out that all of these good things were being paid by money coming directly out of his pocket. At that time, we had the first wage explosion. After the first wage explosion, we had the second OPEC price increase and the tug-of-war was underway. It is that kind of process that has led to the inflationary situation that we live through today. And to compound that kind of process, government developed a great new scheme called indexation. They indexed this and they indexed that, with the result that the system has great difficulty returning to a point of stable prices, to a level of inflation that does not increase and that is sufficiently low to allow financial institutions and financial markets to function properly. This situation has not changed. The diminishing ability of the system to adjust, plus the energy price adjustments, leads me to conclude that we are likely to have a very strong rate of price inflation in this country for the decade of the 1980's. On the plus side, there is a rapid increase in Canada in the investment to GNP ratio, which implies a potential for productivity improvement, an upgrading of our capital stock, and finally a downward pressure on unit labor costs. So the inflation situation is not all that dark, but it is not all that bright either. It is continued high rates but certainly no rapid escalation.

To conclude, I would like to say a few words about the potential of this country and where we are likely to wind up the decade. In terms of potential, if you look at human resources we have the youngest labor force in the world and the second most highly educated labor force in the world. In terms of physical resources, we have an abundance of energy and we have an abundance

of all other major strategic materials. We have an agricultural capacity that can be improved and increased, and we have forests and water and fisheries second to none in the industrialized world. We have an international environment that is extremely favorable. We are a trading nation and there are opportunities for many Canadian industries that did not exist before. Which means that when we add all of the pluses and the minuses, when we look at the issues and how they are likely to be resolved, the 1980's will be a decade of economic development for Canada. There will be slow growth from 1980-1985 and more rapid expansion from 1985-1990. There will be high but declining unemployment. Inflation will hover around the double digit mark. The balance of payments will continue in balance largely because of the debt burden. Finally there will be financial market stability, but interest rates will continue to be high and in line with the inflation outlook that I mentioned earlier. But certainly, Canada is a country that by international standards will do very well indeed in the next 10 years.

MR. GILL: I would like to ask one question, Mr. DeCotret. I am confused by the prediction that we are going to have continued high inflation and that the recession is going to be gradually over. Isn't the purpose of recession to cure the problem of high inflation?

MR. DE COTRET: This returns to my thesis that the current inflation is not the same as inflation of the 1950's or 1960's, typically called demand-pull or cost-push inflation. Inflation could be cured then by slowing the economy down, which reduced the price pressures, or by introducing certain supply management policies, which removed cost pressures. However, we are now in a situation where the inflationary pressures come from a change in the distribution of income which is not accepted by many groups. It is the resulting tug-of-war that is leading to price increases. In that situation, the system cannot adjust and, regardless of the severity of the recession, there will be very little impact on that inflationary process.

MR. GILL: We are going to turn now from the general to the specific. We are going to hear now from Mr. Ashby Bladen. He is Senior Vice President of Investments at the Guardian Life Insurance Company of America. He is also Chairman of the Board of GLICOA, a Director of the Guardian Insurance and Annuity and Annex Realty, and President of the Guardian Park Avenue Fund. Mr. Bladen is a member of the New York Society of Securities Analysts. Before joining the Guardian in 1971, he was a member of Corporate Investments Committee of American Standard, the head of Convertible Securities Research at Salomon Brothers, Assistant to the Treasurer at Cornell University, and Research Analyst at Connecticut Mutual Life. Mr. Bladen is a graduate of Columbia University and the author of the book, How To Cope With The Developing Financial Crisis.

MR. ASHBY BLADEN: Today I am going to talk about the financial problems of life insurance companies that have a substantial ordinary whole life business in the United States. I know that many of you are in other businesses, or come from other countries, but most of you will recognize analogous problems in your own businesses and countries.

First let me observe that life insurance companies, like many other kinds of financial institutions, are essentially products of the nineteenth century. Indeed, our basic business was established upon, and implicitly assumes the continuation of, a degree of stability in the general price level, in the level of interest rates and in the prices of financial assets, that was

characteristic of the last century but that is rapidly disappearing from our late twentieth century world. Many of us are currently wrestling with one or another of a fundamental question -- whether our traditional practices and products can be modified sufficiently that our century-old institutions will be able to cope successfully with the steadily growing instabilities of this new era. I suspect that the answer will turn out to be -- only partially and not very satisfactorily -- at the cost of exposing them to large and ultimately unacceptable risks. A satisfactory future for our industry in the United States depends upon the restoration of price and financial stability, not upon learning to cope with instability.

The very notion of a policy contract that provides both a guaranteed loan or surrender value and a guaranteed minimum rate of return necessarily and inescapably involves an assumption about the range over which interest rates can be expected to fluctuate. The traditional ordinary life policy only worked well when interest rates remained within a range of roughly three percent to six percent. If rates strayed far out of that range in either direction, and stayed out of it for any great length of time, untoward things started to happen. For example, when I was a boy in Hartford the deep thinkers in the industry feared that the life companies would slowly but surely go broke because in the economically mature, capital-rich but demand-poor United States they would not be able to earn the two and a half to three percent that was required to maintain the reserves.

On the other hand, as inflation has accelerated during the last fifteen years, interest rates have repeatedly soared far out of the upper end of that range and have precipitated a series of intensifying liquidity crises for financial institutions in general and life insurance companies in particular. There is very little that we can do to protect ourselves against policy loans and withdrawals on surrender of our existing business except to finance them properly.

Experience suggests that the threshold of disintermediation ratchets upward with each crisis so that it takes a new historic peak in interest rates to provoke a renewed run. However, we generally have had new peaks in rates with each successive crisis. Since inflation has an inherent tendency to accelerate over time, that will continue to be the case. That is why increasing the policy loan interest rate is not an adequate solution to the problem. If inflation is to be a permanent way of life, then we will have to go to a variable policy loan interest rate that is tied to the rates that we could get on alternative investments, and we will have to institute withdrawal charges. But, of course, nothing that is done with respect to new policies will have much impact for many years.

During the nineteenth century, which for purposes of economic and financial analysis lasted from the Battle of Waterloo in 1815 to the Guns of August 1914, inflation was exclusively a wartime and postwar phenomenon. Moreover, responsible governments tried to offset wartime inflation with peacetime deflation, and eventually to restore the gold convertibility of their currency at the prewar parity. Under those circumstances, financial institutions could generally manage to cope.

But our twentieth century peacetime inflation is a very different animal; and it is not clear to me that in the end we will be able to cope.

I don't want to get too far into the theory of inflation and financial crisis today. I am not satisfied with the current theory, which revolves around changes in the money supply, because in these days of inconvertible fiat currencies I cannot see any essential difference between those financial instruments that are counted in the money supply and those that aren't. My own theory revolves around changes in the liquidity of financial instruments.

However, it does not take an enormous amount of insight to discern the basic conditions that have produced our new peacetime inflation. In the nineteenth century the government of the national state did not consider itself to be responsible for the condition of the economy, and it was not in the business of redistributing incomes. In many countries the government did assume some responsibility for the financial system, but only to the extent of providing a sound currency and a lender of last resort in the form of a central bank that supplied liquidity to the credit markets during crises. (In fact, the Canadian government didn't even do that, for the simple reason that there was no capital market in Canada until World War I. The Bank of Canada dates back only to 1935. Before the war Canadians borrowed in London, and occasionally in New York.) During the nineteenth century it was universally recognized that in an unguaranteed economy finance was a risky business, and irresponsible borrowers and lenders could easily go broke. Therefore, people borrowed and lent mainly to finance real investments that provided a means of repayment by increasing the productivity of human efforts.

During the post-World War II era all that has changed. First, the government now does consider itself responsible for the performance of the economy; and for many years that commitment caused borrowers and lenders alike to believe that financial risk had been substantially and permanently reduced. However, after four credit crunches in fifteen years, three of which were followed by severe recessions, perceptive people are beginning to wonder if that is really the case. Second, many governments now attempt to redistribute considerably more income than productive people are willing to pay in taxes, the difference being financed by government borrowings. Finally, governments now lend their credit freely to finance all sorts of projects that the politicians consider to be more valuable than the financial system considers them to be.

When we look at the economy as a whole, there are just two ways in which people can get purchasing power. They can earn it by doing something useful or they can borrow it. Earning purchasing power by doing something useful does not have an inflationary impact upon the general price level. The purchasing power earned is presumably equal to the market value of the useful goods and services produced so that demand and supply are in balance at the going level of prices. But there is no such inherent symmetry with respect to borrowing. The inflationary gap between real output and nominal demand is created simply by debt formation. The inflationary impact is compounded if the new debt is used to buy something other than a productive real investment because then it does not help to close the gap even in the future.

Now, what I have just said goes one step beyond the conventional wisdom. Conventional theory agrees that borrowings from banks are inflationary if they do not finance a corresponding increase in real output. Bank loans are considered to create purchasing power because the borrower has gained the purchasing power but the person who originally deposited it in the bank has not lost it. He can always withdraw his deposit and spend it. But a loan from any other source, for example a life insurance company, is not considered to create purchasing power. Our depositors -- who we call policyholders -- are

thought to have alienated their purchasing power until our investments mature and are paid off. That is the clear implication of conventional monetary theory; but it cannot be right because, as you know very well, our depositors also retain the right to withdraw their deposits when they wish. If it were true that life companies cannot realize on our investments until they mature, some of us would very likely have gone bellyup three times in the last ten years.

In fact, life companies can realize on their investments either by selling them on the market or by pledging them as collateral for loans. Those are exactly the same things that a commerical bank does. The only significant difference is that the central bank acts as a lender of last resort for the commerical bankers, and they in turn act as lenders of last resort for all the rest of us. In the end the solvency and stability of the entire financial system rests upon the commitment of the central bank to keep all assets adequately liquid.

However, the political policies of the late twentieth century have created such enormous incentives to borrow and spend that, as long as the financial markets are liquid and credit is readily available, the rate of inflation is undesirably high. That in turn produces a level of interest rates that threatens disintermediation from financial institutions. There are at least two causal links between high inflation and high interest rates. First, savers quite reasonably believe that they deserve a real rate of return after inflation and taxes for the use of their savings. True, savers have not actually achieved a real return in the United States for several years. For example, after inflation and taxes mutual life insurance companies are producing substantial real losses for the savers who own them despite the efforts of the life company investment officers. Second, when the rate of inflation becomes politically intolerable the only really effective policy response that we have yet discovered is for the central bank to refuse to make available all the credit that the market demands. When that happens, the amount of credit that remains available is rationed by price.

At some point, rising interest rates produce both a financial crisis through disintermediation and either a recession or a crisis, or both, in the real economy through credit rationing. Rising interest rates make marginal projects uneconomic and therefore unfinancible. The biggest and best example of this is usually housing. The lowering of debt service coverage ratios that is caused by rising interest rates also makes marginal borrowers unfinancible, threatening them with bankruptcy. At some point conditions in the real economy get so bad and the level of unemployment gets so high that the central bank decides that it has to relax the squeeze, and the cycle of inflationary expansion - credit crunch - recession starts all over again. That is a brief theoretical description of the two horns of the dilemma between which our economy and financial system have been shuttling unhappily for the last fifteen years. The business cycle in the United States is becoming steadily less of an inventory cycle in the real economy, and more of a financial cycle caused by the incompatibility between the political goals of price stability and full employment.

The secular trend is clearly toward higher rates of inflation, and therefore new peaks in interest rates during each successive crunch. That is because the financial system is adjusting to inflation, and the nineteenth century defenses against it are steadily being dismantled. First the convertibility of currency and other financial claims into precious metals was dismantled.

Convertibility was a constraint against inflation because it gave holders of financial instruments a chance to opt out of the financial system altogether and take refuge in precious metals. That would reduce the ability of the system to indulge in an inflationary overexpansion of credit. Now Regulation Q, which used to limit the interest rate that banks could pay on deposits and therefore caused disintermediation from the banking system during crunches, is also gone. This progressive dismantling of the financial constraints that used to defend the system against inflation by causing it to produce painful disintermediation means that the level of interest rates that is required to produce the desired result is steadily rising.

It also means that the financial institutions that remain subject to those nineteenth century restraints are in progressively greater danger. And that means us. Today it is not commercial banks that are in danger of disintermediation; they have learned to protect themselves against it. The threatened institutions are those that still invest in long-term claims, like the savings banks with their mortgages. They cannot afford to pay the interest rates that would be required to hold on to their deposits because the yield on their portfolios cannot rise as fast as the yields available in the marketplace. However, the Depository Institutions Decontrol Act of 1980 considerably broadens the powers of thrift institutions. They are in a liquidity crisis now, but over the years the American financial system is likely to move toward the Canadian system of few but strong and flexible banks. That will leave the life insurance companies in the United States, with their nineteenth century guaranteed cash loan and surrender values, as the most exposed institutions in the system.

Let me make one more theoretical point before I turn specifically to our own problems. When the inflationary process has gone as far as it already has in the United States, it has to end in a financial disaster of one sort or another. Once a financial system has evolved to the point at which credit has become readily available the only thing that ultimately can keep it stable and avoid the inflationary overexpansion of credit that is now occurring in practically every country in the world is the prudent self-interest of borrowers and lenders alike in avoiding financial trouble. As we have seen, practically all of the mechanical and institutional safeguards against inflation that existed during the nineteenth century are either gone altogether or are in the process of being dismantled. I said earlier that if inflation is to be permanent then guaranteed cash values and policy loan interest rates that are fixed in the contract will also have to go. I expect them to go when financial crisis hits the life insurance industry.

If you ask me how those provisions can possibly be changed in view of the fact that for us to change them unilaterally would be abrogation of contract, I will have to answer that I cannot foresee the details, but I do know that it is possible in a crisis. Before 1934 every self-respecting financial contract in the United States stated that the debt was payable either in currency or in gold at the creditor's option; and every financial man in the country would have said that that provision was the essential foundation of our financial system and could not conceivably be abrogated. But in 1934 the Congress did abrogate it, and the Supereme Court found exceedingly specious grounds for upholding the abrogation. Crises have produced bad law in the past; and doubtless they will do so again the future.

The net effect of many well-intentioned but unwise twentieth century political policies has been to short-circuit that prudent self-interest in avoiding financial trouble. Today borrowers believe that the way to stay ahead of

inflation is to be as heavily in debt as possible, and lenders believe that the inflation will bail out their bad loans. The only thing that can restore the requisite degree of prudence is a series of bankruptcies, defaults and losses that will again force us to realize that finance is inherently a risky business.

When I wrote my book I was still reasonably certain that such a financial crisis would occur before inflation had substantially wiped out the real value of the wealth that is held in the form of financial claims so that the basic structure of our financial system would survive relatively unscathed. Today I am not so sure. Three things have shaken my confidence. First, the Carter Administration is diligently bailing out everybody whose failure would be politically unpalatable regardless of the irresponsibility of the financial behavior that got them into trouble and regardless of the risk that they will not be able to repay their bailout loans. Chrysler Corporation, for example, has always been speculatively capitalized, and given the prospects for the automobile industry in the United States it is virtually certain to become a Yankee version of British Leyland. It will run at a huge loss for years, with the losses being picked up by the American taxpayers. Second, there is the rapidly rising political appeal of a substantial cut in personal tax rates unaccompanied by an equivalent cut in federal expenditures, with the gap financed by increased government borrowing. Finally, both illegal businesses like the drug trade and tax evasion by otherwise legitimate enterprises are growing by leaps and bounds.

By now probably something over 10% of all economic activity in the United States takes place in the subterranean economy, and that is well beyond the flashpoint. From now on simple envy of people who are doing splendidly in illegal businesses like the drug trade while passing their share of the tax burden on to the rest of us will cause the subterranean economy to grow at an explosive rate. In my book I warned that we are heading for an eventual crisis in Federal Government finance, and recommended the substitution of a value added tax for the income tax before it breaks down altogether.

If the bailouts, soaring government deficits and rapid growth of the subterranean economy all continue, then it is possible that we will end up with hyperinflation and the complete destruction of the accumulated wealth that is held in the form of financial claims. In that case there is really not much that the life insurance industry can do that will benefit our customers. The one thing that we can do is to use every opportunity to point out that that is the direction in which we are heading, and that is where we will wind up if we do not elect financially responsible politicians who are determined to end the inflation. Unfortunately we do not have much of an opportunity to elect financially responsible politicians in the United States this year. Fortunately, however, hyperinflation is still highly unlikely in the United States. A deflationary crash is by far the more probable scenario.

Turning now to the problems of the life insurance industry, the first point that I would make to actuaries is that we no longer have any reasonable basis for making any assumptions whatever about the range within which interest rates will fluctuate in the future. Certainly past experience does not provide such a basis, for within the last half century interest rates have gone far out of their historically normal range at both ends and stayed out of it for long periods of time. Nor does rational forecasting provide such a basis, for it is impossible to be certain whether the present

accelerating inflation will end in hyperinflation and astronomical interest rates or deflation and low interest rates. But we can be reasonably certain that it will eventually end in one or the other. Inflation in the high single digits or low double digits is not a stable condition that can last indefinitely because people will increasingly take evasive action that will cause it to continue to accelerate.

This point is critically important in your work, because as you know the combination of inflation, high interest rates and the Life Insurance Company Income Tax Act of 1959 are causing changes in the life insurance contract that implicitly assume that the present situation will in fact continue indefinitely. For example, there is a growing trend toward increasing the assumed interest rate on participating whole life policies. That has the effect of lowering both the premium and the dividend. It also produces an income tax saving, and reduces the net cost by the amount of the tax saving. But it obviously also reduces the margin of safety in our business. We can cut or eliminate dividends if necessary; but a company that fails to earn the assumed rate on its reserves eventually becomes insolvent. Even so, competition will tend to force the industry as a whole to conform to the most optimistic assumption that any company makes. This year the Guardian has gone to a 4% assumed rate as a matter of competitive necessity. However both I and our President and Chief Actuary, John Angle, have nailed our flags to the mast at 4%; and are prepared if necessary to go down with all guns firing. Some other companies are going to 4½%, and there is serious talk of even higher rates. If the inflation continues, it will eventually accelerate to levels with which our industry cannot cope so that our long-run prospects depend upon a return to price stability. But if stability is restored, the risk that we will not be able to earn 4½% or more over the long run is very great.

This is just one example of a general trend within our industry toward progressively less conservatism at the same time that the risk of serious economic and financial trouble is rapidly rising. Another example is the ratio of surplus to liabilities, which for the industry as a whole peaked in the mid-1960s and has since declined substantially. The combination of inflation and the Tax Act is a poisonous one that virtually forces us to act with progressively less prudence than has been traditional in our industry. In the end we cannot coexist with the Tax Act either and we should redouble our efforts to get it changed. For a judicious discussion of other ways in which the interaction of inflation and taxes is causing us to abandon caution and accept increasing risks I refer you to a paper by John Angle that is reprinted on pages 188-193 of the Society of Actuaries' Record, Volume 6, Number 1.

One risk that is covered in John's paper is the state insolvency laws, which in many states subject us to a potential liability that is not only completely beyond the ability of the individual companies' management to control but the magnitude of which is totally unpredictable. So far the insolvency laws haven't done much damage because there haven't been many insolvencies; but I suspect that there will be at least a few during the 1980's. Requiring sound and responsibly run companies to bail out the irresponsible failures is a dumb idea, and during the next several years it is likely to cause serious damage.

The most immediate danger results from the tendency of companies that went into the last period of disintermediation with heavy forward commitments to finance the squeeze by issuing commercial paper. That is just about the most dangerous thing you can possibly do. Go to the banks, instead, even when it costs substantially more in interest. When the next crunch comes and your friendly banker asks you to pay off your loan you can say, "I don't have the money." Then he has two choices. He can put you into default, in which case he will have to carry your debt as a bad loan, or he can reflect that this is merely a temporary liquidity crisis afflicting a fundamentally sound and solvent company and ride along with you. But if you have outstanding commercial paper mature at a time when market conditions make it impossible to roll over, you are in real trouble.

A minor drawback of issuing commercial paper is that it subjects you to scrutiny by Moody's and Standard and Poor's as well as by Best's. So far they have given all life company paper a prime rating, but if the amount outstanding continues to grow at anything like the rate it has this year, they are bound to take a more careful look; and discover that the financial ratios for the life insurance industry in general and many individual companies in particular have been deteriorating for years. Since our main stock in trade is really our reputation for financial strength and prudence, it would be a bit of a disaster for any company to have its paper downgraded to less than prime.

Now, I would like to conclude with a business cycle forecast that would also tell you when the next crunch, and the attendant risk that commercial paper would become unsalable, will arise. At the moment, I find that impossible to do. Inflation and economic expansion are on a collision course. By now the inflation is so bad that even during recessions the interest rates do not decline far enough or stay down long enough to permit financial institutions to refund their short-term debts at long-term, and thus prepare to finance a renewed expansion. The recession of 1980 is the first time that this traditional recovery of balance failed to occur. The consequence is that the financial system of the United States is going into the expansion with an unprecedented high portion of its liabilities in short-term and interest sensitive form. For example, many of the stock life companies are turning into corporate pension fund investors and corporate pension funds are potentially volatile. The result of all of this is that the economy of the United States is becoming increasingly unstable and the financial cycle is speeding up. Interest rates are at the threshold of disintermediation now. At some point, the expansion will abort in a financial crisis, but it is impossible to predict just where that point lies. A vigorous recovery would produce an extremely severe crunch very soon. Conversely an anemic recovery could delay the crisis for some time. What is clear is that our financial system can no longer stand prosperity. Now, given the institutional rigidities that our industry is subject to and the competitive nature of our business, there is not a great deal that we can do about this. I urge you to be as cautious as possible about accepting additional volatile liabilities and I beg you to pay off that commercial paper as soon as possible.

During the last decade the people of the United States and our political leaders have persistently refused to face up realistically to our problems. Thus in many areas, not just the financial one, the problems are becoming crises. You may recall that 10 years ago President Nixon informed us that we had probably fought our last war and that we could safely go to an all volunteer military establishment. Unfortunately, the decision whether to fight a war is not necessarily within the discretion of a single nation.

President Nixon did not know, and probably did not care, whether the all volunteer army would work. A decade later, it appears that it does not work very well and now that we face a potential crisis that would threaten economic disaster, the ability of the United States to influence events in far places is probably the least that it has been since the Cold War began. The root causes of these problems are political, and the solutions must also be political. Given the caliber of the candidates in the United States this year, that suggests that we will experience at least four more years of intensifying financial crises.

MR. GILL: Mr. DeCotret, would you like to respond on one or two points?

MR. DE COTRET: There is a direct and strong correlation between the financial responsibility among politicians and their desire for early retirement. I agree with Mr. Bladen that there is a real problem there. The problem is that the electors place demands upon those elected for goods and services that they are not willing to pay for.

In terms of our respective analyses of inflation, they are very complementary. If you look at inflation as an income distribution problem, the only way that tug - of - war can produce the inflationary pressures I mentioned is if you have the liquidity provided in the system for one group to recoup purchasing power at the expense of the other. Obviously that occurs through the credit expansion process.