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BUSINESS AND INVESTMENT OUTLOOK

Leader: DONALD R. SONDERGELD
Speaker: BERYL W. SPRINKEL *

MR. DONALD R. SONDERGELD: It's my pleasure to introduce our keynote speaker who is economic consultant, Dr. Beryl Sprinkel. Dr. Sprinkel served as Chairman of the Council of Economic Advisors and provided economic analysis and advice to President Reagan. Prior to that, he served for four years as Under Secretary of the Treasury for Monetary Affairs. In that position, he was responsible for formulating and implementing domestic and international financial policies. Dr. Sprinkel was also Executive Vice President and economist at the Harris Bank in Chicago. He has taught economics and finance at the University of Missouri and the University of Chicago, and is the author of two books and coauthor of a third on the effects of monetary policies on financial markets and the economy.

Dr. Sprinkel will speak on monetary and fiscal policy developments in an election year and analyze inflation and growth prospects. He will discuss the prospects for economic recovery in 1992 and the probable impact on interest rates and investment markets.

DR. BERYL W. SPRINKEL: I'm delighted to have the opportunity to address the Society of Actuaries on some issues that I consider to be important. Now I realize it's to talk about that *dismal science of economics* for some of you at least. I never found it dismal, thank goodness, because I've been in it as a career now for a long, long time. I still find it exciting, challenging, and even sometimes, profitable.

Let me first cite some obvious strengths that we tend to ignore when we concentrate on problems that I will discuss later. First is the probability of a sustained recovery, now that we're getting our second leg up on this expansion.

The U.S. remains, as I'm sure many of you know, the largest, but also the most productive economy in the world, and we, of course, are the lone remaining super power.

That's not too bad for starters. We have the highest standard of living, also as a result of having the most productive economy. And fortunately, our inflation has receded to quite low levels, even compared to most of the rest of the world. And at long last, an economic expansion is under way, which promises higher production, employment and profits. Communism has been rejected and peacefully defeated. And formerly Communist countries in eastern Europe are struggling to adopt capitalism and democracy, with the assistance of the United States and other developed nations, through the international financial institutions, the World Bank, the IMF and other agencies.

Consequently, defense expenditures in the U.S. are justifiably on a declining pat. Not as declining as I had hoped, however. Congress complained about the

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Administration not cutting back enough, and then Congress refused to cut what has been proposed, because of the short-run effect on jobs. We clearly won the twentieth century's most significant and costly, political and economic debate. Yet, we're faced with serious economic and social problems, despite these many achievements.

The economy is now in an expanding phase of the cycle, and better news should penetrate the media in lieu of the gloom and doom that's long been our fare. Following a renewed expansion in monetary growth and rising leading indicators, the first quarter gross domestic product (GDP) rose at an annual rate of about 2%. It'll probably be revised upward slightly. That's the highest growth rate since I left Washington in early 1989. Now I draw no correlation between those two events. But I do believe growth policies have been significantly reversed in the past three years. And I will talk about those later.

I've long believed that given the proper incentives, a market economy tends to grow, not stagnate nor decline. The recent recession was due to mistakes made in Washington, not mistakes in the marketplace. There are, unfortunately, three, I believe, good reasons for expecting a relatively slow expansion. I frequently try to avoid agreeing with the general consensus, but in this case, I think the general consensus is going to be right. It's going to be a very modest recovery, but up instead of down. First, policies no longer foster high growth and I will return to that issue later. Second, historically there has been, for good reasons, a strong positive correlation between the depth of a recession and the rapidity of the subsequent recovery. The recession that we suffered through, as economists will probably date it, lasted only two quarters plus a few weeks. The National Bureau of Economic Research has not yet decided the trough of that recession or the peak, but it probably lasted a little over six months and ended in the spring of 1991. It may not have seemed like recovery, since it was a very, very slow recovery, but in general, the economy is above where it was a year ago. Also, the recent recession was a mild downturn, compared to prior recessions, and that's the point I want to make.

Unemployment rose from 5.3 to 7.3%; real GNP went down, but not much. In contrast to prior expansions, real growth during the past three quarters has averaged only 1.4% and that's very slow. And that's nearly identical to the 1.5% average rate during the seven quarters preceding the downturn in the economy. So, historical data also show that postrecession growth usually approximates prerecession growth, unless basic policies are changed, and they haven't been changed for the better recently. So I think the best bet is that it will be a mild recovery. It still would be better than going down, but not very good.

During the first quarter, much of the 2% rise in real GNP was due to a spurt in personal consumption spending, which, of course, can only be sustained if employment and income levels rise more rapidly. These levels are beginning to show somewhat more rapid growth than previously. The first quarter for business fixed investment dropped slightly, as weakness in commercial real estate persisted. From a positive point of view, final sales advanced at a 4.8% annual rate, more than twice the rate of real GDP as businesses reduced inventories at a sizeable clip. This is about a \$26 billion annual rate of decline. Real residential fixed investment continued strong, up about 15.8%, following an annual rate rise of 13% during the second half of last year.

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Despite improving domestic demand, the real trade deficit narrowed further in the first quarter, from \$21 billion to about \$18 billion. Exports and goods and services rose about 1%, while imports fell 1.5%. Defense cuts reduced growth for the fourth quarter, actually for the four consecutive quarters and the last quarter, with defense outlays on a national income basis declining at a 1.6% annual rate, following a 15.7% drop in the preceding quarter.

Real GDP, excluding defense, averaged 2% over the last four quarters. This is compared to 1.5% including defense, so defense has been a drag in the short-run performance of the economy and is likely to remain so in the months ahead. Although defense cuts can weaken the economy in the short run, they, I think, should be looked upon as a positive for us, once resources are reallocated to more productive uses. Unfortunately, that requires effort and time. The GDP deflator was up only modestly in the first quarter. Much of the increase was due to a pay raise for the federal government, which occurs only once a year. Excluding the pay hike, the deflator rose at an annual rate of 2.3%, following 1.7% in the prior quarter.

There is little evidence that the pace of rise is increasing much in this quarter. Although inventory change will contribute significantly to this quarter's improvement, as companies step up the pace of production to meet demand, real consumption outlays are likely to register only a moderate increase. Export growth may continue to slow as several major customer countries experience slow growth or recession, and imports may rise as incomes go up. The trade deficit rose sharply last quarter, due to a decline in exports. Recessions or no growth in Germany, Japan, Canada and a few other countries, and of course, ours, is improving, and when that occurs, imports tend to rise. Residential investment is likely to remain strong in this quarter, even though the most recent report on housing starts, as you well know, was adverse. I think corporate profits will continue to improve, reflecting slower wage increases, as well as improved productivities. Improving trends, I think, will last throughout the year and longer. Let me turn for a moment to the inflation outlook and financial markets.

Not only is real output likely to continue to grow at a modest pace in the months ahead, but also inflation will continue to be restrained. Inflation has always been primarily a monetary phenomenon, and the U.S. is certainly not an exception. Following accelerating growth in the money supply in the 1970s, and volatile money growth in much of the 1980s, although at a somewhat lower level, growth and money has been moderate and more stable in the past four years, with M2 averaging a growth of a little over 4% a year. And in fact, in the past two years, that growth has averaged 3.33% per year. Historically, inflation has lagged monetary growth per unit of output about one-and-a-half to two years. That is, what happens to money today will influence inflation one-and-a-half to two years from now. So the prospects presently are quite favorable. We've had a moderate monetary policy and, in my opinion, a good one. During the past year, consumer prices have risen 3.2%, and producer prices are up a little less than 1%. And most recently, they both rose very slightly, up 0.2% that is, both the CPI and the producers prices.

Furthermore, most of the short-term indicators that have reliably forecasted inflation changes in the past remain favorable. Gold prices continue very restrained, well off their highs of a year or so ago. And even well below what they were at the beginning of this year. Many consider gold prices to be the ultimate inflation

barometer, and certainly the record has been good and should be noted when you're looking at the prospects for inflation. Furthermore, both the Commodity Research Bureau (CRB) futures index of commodity prices and the Dow Jones futures index of commodity prices are near their modern low. So they are still on the downside mostly and the prospects for inflation then in the year ahead are quite favorable and I think improving somewhere between 2% and 3% per year, which isn't very much compared to our recent history.

I attribute most of the improved prospects for inflation to a much improved performance of the Federal Reserve system, under the leadership of Chairman Alan Greenspan. Change in relative prices such as food and energy can bring short-run changes in reported inflation. Only the Federal Reserve can determine the trend rate. It had a meeting of its major committee, the open market committee, and rumors coming out of there indicate no change in policy at the present time.

Well, investors should be interested in the trend rate of inflation, because it has disparate effects on the rates of return earned on financial and real assets. In general, accelerating inflation brought on by easy money brings high rates of return on real assets, such as land, homes, commercial property, gold and silver, while yielding low or even negative rates of real return on financial assets like bonds and stocks.

Conversely, disinflation, that is a slowing rate of inflation or even a deflation, brings low or negative returns on real assets, while financial assets prosper. The decades of the 1970s and 1980s were only the most recent examples of this investment phenomenon. Fortunately for my net worth, Robert Geuetski, of Robert Geuetski and Associates, and I wrote and published a book in 1977 dealing with these issues that documented and attempted to explain why those facts tend to repeat decade after decade. I hope therefore that you held a lot of real assets in the 1970s and then got out and switched to financial assets in the past decade, which has been the period of disinflation that was extremely important. Furthermore, continued disinflation moving toward price stability lies in our near future. Higher money growth leads economic activity with a shorter lag, that is six to nine months, but it leads inflation with a much longer lag, and therefore, we can be generally confident in 1992 and well into 1993 about the favorable trend rate of inflation.

However, the groundworks for higher inflation often occur in periods like now, that is, periods when you have recession or slow economic performance and especially periods leading up to a political election. Therefore, I'll watch what happens to the Federal Reserve very carefully. My home state is Missouri, the Show-Me State, and so you don't just take what they say as an article of faith. Follow the numbers. Fortunately, it's very easy to do. The numbers are published each week, and up to the present time, I think they're pursuing a moderately expansive policy, which is the right policy to encourage some growth in the economy, but not so much as to encourage inflation. Now if the Federal Reserve was to pursue a policy of very rapid growth, say an M2 over a considerable period of time, inevitably more inflation will be in our future. And we need to watch it. My guess is that the performance of the Federal Reserve during this period will be fairly similar to what it was in 1987. In 1987, the Federal Reserve pursued what I believed then, sitting in the White House (I might have been influenced by that fact), to be an excessively tight monetary policy, and in any event, the market came crashing down and I think the Federal Reserve

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made a major contribution to that crash. But, the important point is that shortly afterwards, like the next day, the Federal Reserve eased monetary policy, and remained quite easy for a few months. There was beginning to be concerns that the Federal Reserve would remain so easy, given that an election was coming up, that it would lead us back into inflation. But once it became evident that the market break was over and the economy wasn't going to move into a recession, the Federal Reserve moved back to a very moderate policy and we avoided a lasting renewal of inflationary pressures. Careful monitoring of monetary policy developments in 1992 is, nonetheless, strongly advised.

Presently, the yield curve for those of you who follow financial markets is unusually steep and is likely to become less so in the months ahead. In fact, it's been in the process of becoming less so since I wrote those words, about a week ago. I suspect the moderation will come in the form of a modest rise in short-term rates, as the recovery proceeds and that hasn't happened yet. Short rates are very near their low. But also, there is a significant decline in long-term rates, as it becomes increasingly clear that the inflation threat is receding, at least for now. And very recently about a quarter was knocked off of the long-term government rate, which was around 8% before and is close to 7.75% now. With expected inflation of 3% or less for the period ahead, 30-year government securities should be nearer a 7% yield rather than the recent 8% yield that we noted.

The decline in interest rates that occurred in 1991 and up to the present in 1992, of course, has been a major factor compelling the stock market to historically hide price-to-earnings ratios (PEs), but further moderate advances are likely, if profits continue to improve in the period ahead. Since both Germany and Japan are entering a period of either very slow growth or recession, following a very tight monetary policy in each country, their policies are likely to be eased somewhat in the months ahead, bringing lower rates of interest. Such trends, I think, will favor the dollar, vis-à-vis the yen or the deutsche mark.

Let me turn to some long run growth problems. Although the U.S. economy is likely to improve moderately in the months ahead, serious economic challenges, I think, face us as we contemplate moving to the next century. I believe the most serious economic problem is lack of adequate growth incentives. Although economic growth does not solve all problems, and in fact, may, in the short run, exacerbate a few, without growth things are a lot worse. Jobs become scarce. Unemployment rises. Standards of living decline. And federal revenues, as well as state revenues, are not available for helping solve a plethora of economic and social issues. Budget deficits rise and the risk of inflationary finance increases. Most countries in the world that run large deficits end up with large inflations, primarily because those countries finance the deficits at their friendly central banker. That's the only alternative they have. They can't go out and sell securities to their own citizens or to other citizens of other nations. That isn't true in our case. That is, we have been able to finance our enormous deficit in mostly a noninflationary way, but that doesn't mean we can do it forever, especially if those deficits continue to rise.

Certainly social tensions arise in such an environment, that is, of low or no growth. An economic policy may tend to focus on redistributing the pie and leveling out incomes rather than what can we do to increase the production of the economy, and

hence, our standards of living. Certainly the ongoing debate between the Congress and the Administration on growth policies versus higher taxes has greatly intensified during this period of very slow growth over the last three plus years.

Now achieving superior economic growth is no mystery. It's not a debatable issue in my opinion. Economic theory and now numerous experiments around the world reveal very clearly the answers. We may not want to choose them, we may say, no, we'll go for a very slow growth society and go the other way on policies, but at least we know what has to be done if we are going to encourage unusually good growth. Inevitably, those nations that rely on private ownership and a free market system maintain high incentives for savings and investment in both human and physical capital, provide strong work incentives, maintain disciplined monetary and fiscal policies, and adopt a freer trade stance, vis-à-vis other nations also inevitably achieve superior economic growth. If you increase the incentive to do those kinds of things that encourage productivity improvement, you will end up having better growth in other countries.

During President Reagan's Administration, when I spent eight years in Washington, the policy thrust was toward improving incentives to work, save and invest, by trying to do several fairly simple things, none of which we fully achieved. We tried to slow the rise in federal spending. There was some progress there, but not as much as I had hoped. There was considerable progress in reducing marginal tax rates. And the idea, again, is very simple. If you can keep more of what you earn, you're likely to work harder, to exert greater effort. People who previously wouldn't be in the labor force, come into the labor force because of the higher margin of return, and of course, that's exactly what happened. We reduced excessive and costly regulations of business, which discourage job creation, and discourage growth and output. Finally, we supported a monetary policy designed to reduce inflation. As I suggested, policy objectives were not fully achieved, but major progress ensued, and the resulting recovery and expansion was long. It was sizeable, and it was widely shared. It lasted 92 months. That's 3.5 times the length of the average expansion in our history. And it was the longest peacetime expansion in history. Real GNP rose an average of about 4% per year during that economic expansion. Employment increased 19.3 million good jobs, and unemployment declined from well over 10% to about 5.3% in 1989. Private investment rose 71% over that period in real terms. Per capita real income rose 18.8% and average real income rose in each income group, although not equally: those individuals who had better skills and higher educational levels gained more than those who did not. Real exports increased 92.5%, and inflation decreased from 13% to about 3-4%.

Most interest rates peaked in 1981 with the prime topping out at 21.5%, and I had to look it up to make sure it was that gross. Interest rates have been generally declining since that time, with the prime rate, of course, now set at 6.5% and with unusually wide spreads, vis-à-vis other short-term interest rates. Stocks soared in the 1980s until 1987, when the sharp contraction occurred, and then, of course, disinflation ruled the decade.

Furthermore, and this is usually ignored or not understood, the rich ended up paying a higher percentage of the total tax bill as the Reagan tax reforms increased productivity

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and the efficiency of the tax system. That was our intent, and that, in fact, is how it's worked out.

For example, in 1981, the top 1% of taxpayers paid 17.6% of the total tax bill, and in 1988, after all tax reforms, they paid 27.5%, so 17.6% versus 27.5%. The top 5% of taxpayers paid 35.1% of the total tax bill in 1981 and 45.5% in 1988. That was a 10% increase. The lowest 50% of taxpayers paid 7.5% of the total tax bill in 1981 and 5.7% in 1988. In addition, about four million low-income taxpayers were removed from the tax rolls by the reforms. The Reagan expansion facts, in my opinion, remain unchallenged, despite the extensive efforts of liberal commentators and press to denigrate the economic achievements of the Reagan Administration, of which I was proud to be a part. So you may interpret that I'm a little defensive. I'm not defensive, but I do insist on keeping the record straight.

Unfortunately, many pro-growth policies were reversed in the past three years and real growth deteriorated to an average of about 0.6% per year. Employment over the past few years stagnated at around 117 million persons in recent years, and unemployment rose to 7.3% of the civilian labor force until the recent decline to 7.2%.

President Bush has subsequently stated he wished he had never signed the 1990 budget agreement. I wished he wouldn't do it at the time it occurred. Unfortunately, he did. Federal spending soared 28.9% from 1989-1992, that's a lot, nearly a double-digit average during those three years. Spending rose to 24.9% of GDP from 22.3% in 1989. So now about a quarter of GDP, when it comes out, is the federal government. Costly regulations of businesses ballooned, whether measured by regulatory budgets, personnel or the number of regulations printed in the Federal Register. Again, the President was horrified by some of these numbers and, over the past two or three months, called a moratorium on new regulations and, very recently, has been reversing some that previously were in place.

Now if we're to restore the long-term growth rate to acceptable levels, we must get back to the basics of restraining federal spending, increasing incentives for saving for investing and working, limiting regulations of the market process, and maintaining the low levels of inflation that now exist, while promoting freer trade with our neighbors, Canada and Mexico, and the rest of the world, by assuring a successful conclusion of the North American Trade Agreements, which are making progress, and the GATT trade negotiations, which so far as I can tell, have made no progress of late.

A pro-growth economic reform program must include effective restraint on budget expenditures, which now represent, as I said, a quarter of all goods and services produced. High levels of federal spending absorb resources that can be more effectively deployed in the private sector, and inevitably mean higher marginal tax rates which discourage growth and discourage increases in jobs.

During the 1985-89 period, when Gramm-Rudman was in effect, federal spending as a percentage of GDP, declined from 23.9% to 22.3%. That's not a lot, but is significant, nonetheless. Under the Budget Control Act of 1990, federal spending rose to a quarter of GDP. The President desperately needs item veto authority which he isn't likely to get, even though most governors have it. With it, he could then veto

individual items in the budget without the necessity of rejecting the total budget and hence, shutting down the federal government. We did that for two or three days once, in the Reagan Administration, but it's a horrifying affair. You can't even send out Social Security checks, for example. When he tries to reject the budget that came down from the Congress, he doesn't have the power to knock out those areas that are excessive in order to work down toward a balanced budget. But if he had it, then he should be held responsible for the budget. Some constitutional lawyers believe that the President of the United States now has the authority to exercise an item veto. Unfortunately, the idea has not been tested in the courts, and although some friends of mine in President Bush's administration said they were going to do so, at least up to now, they have not.

A balanced budget amendment would be a useful budget control provided it was accompanied by a provision that required primarily spending restraints rather than higher taxes. At long last, the balanced budget agreement is getting a lot of attention in the Congress. And something is likely to pass. What I fear will pass will be a balanced budget agreement that mandates that the budget be balanced by a form of raising taxes. Unfortunately, each time taxes go up and out of our pocket, that leads to more spending. We need some kind of a super majority required in order to raise tax rates, otherwise, we'll end up with even a larger government vis-à-vis, our total economy. More revenues inevitably lead to more spending, given the way Washington works.

The payroll tax used to finance Social Security is a major tax deterrent of job creation and has risen sharply in recent years. Alternative financing schemes should be considered there. Many taxpayers, as you well know, now pay more social security than income taxes, and of course, employers pay an equal amount. It is very difficult to create jobs when those taxes go up. The return to capital investment needs to be increased by permitting direct expensing of capital outlays or something similar to that. To encourage new and smaller businesses and job creation, the capital gains tax should be substantially cut and indexed, or eliminated, as in the case of many developed countries. For many years most jobs have been created by small and moderate-sized businesses in the private sector, not in government and not in large businesses.

Savings should be encouraged by an expansion of IRA benefits, while achieving fiscal discipline and hence, pulling down the size of the federal deficit, which is horrendous, and of course, continuing to encourage stable prices. All those moves would work in the direction of raising a savings rate that is unusually low in this country, compared to many others around the world. The explosion in regulatory rulemaking recently encouraged President Bush to impose a moratorium and a review of past regulations with the intent of easing those that seriously inhibit growth, and some action along those lines has already occurred, and I think these efforts should be supported and extended. Marginal tax rates must not be increased, if we want to encourage effort and savings and investment, and should eventually be further reduced, once we get the deficit under control. Finally, the Federal Reserve deserves support in its efforts to restore price stability.

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Well, the required policy thrust for promoting accelerating growth and job creation is clear. I think it's clear and if you look at the evidence, I believe you will think it's clear. One of the things I've done, over the past three years since leaving Washington, is teach a course on economic growth at the University of Chicago, and I've had an opportunity to go back and look at a lot of the evidence. And I think it's very clear, but just because the evidence is clear, doesn't mean it's going to happen. After listening and participating in the political debate over the last decade, I conclude that the political will is lacking. Perhaps the strong movement toward term limitations, amid dissatisfaction with congressional performance, will help break the current gridlock between the Congress and the Administration. But it hasn't happened yet. They can agree to spend more money, but seldom can they agree to cut money or to adopt taxes that encourage growth.

I think it would be ironic and tragic if the U.S. were to move further toward income redistribution, as it appears to be going, and even fewer growth incentives, which is the inevitable result, just as former Communist nations strive to join our capitalistic and democratic system. We must not follow our win of the greatest intellectual debate of the twentieth century, by moving away from our successful system based on incentives for individual achievement, toward greater emphasis on equality of results, because that system failed in Communism and would fail in our world. It's up to each of us in this participatory democracy to make sure that those catastrophes do not occur. I think posterity deserves no less.

FROM THE FLOOR: Actuaries must make very long-term projections.

DR. SPRINKEL: Good luck.

FROM THE FLOOR: And without knowing what policies will be adopted in the future, I'd ask you to focus on two of those projections. Social security makes projections over the staggering 75-year period. One of the assumptions it must make is regarding inflation; the trustees have assumed an average 4% long-term rate. The Social Security technical panel recommended that be raised to 5%. The second projection deals with real wage growth, where there is an estimated 1.1% increase in real wage growth over the long term, the Social Security technical panel suggested lowering it to 1%.

DR. SPRINKEL: What was the first estimate on real wage growth?

FROM THE FLOOR: A 1.1% increase is what the trustees are using for this 75-year period. The technical panel recommended 1%. Both of those numbers are well above what we've had in recent years, more reflective of long-term trends. If you had to make a best estimate for these two things, what would you come out with and how would you go about it?

DR. SPRINKEL: Well, the future is always obscure. You have to recognize that. You may be able to look into the near-term future with a high degree of certainty, because you know what's going on now and what went on yesterday and where the pressures are presently. But you're talking about an impossible period of time to have great confidence on your predictions. Now let's first look at the inflation point. Vis-à-vis most countries around the world, we've done relatively well. The three countries

that have done the best over, say, a little less than the last 50 years are Germany, Switzerland and the United States. And all three of them have a high degree of independence in the central bank. And some central bankers, even though independent, tend to do an inflationary job and some do not. So you can't be certain that, even though we have a high degree of independence in the central bank, that the chairman will perform well, although on average, over a long period of time, the three countries have done fairly well. It was true up until World War II that one could say with high confidence, that inflation wasn't going to go anywhere because the price level in 1939, as best as you could measure it, was approximately equal to the price level in 1839, i.e., 100 years before that. In the middle, prices went up and they went down but they didn't go anyplace. Beginning in World War II and up to the present time, prices rose but never went down, i.e., we have been unwilling to go through a sharp protracted depression, which is what would be necessary to actually get price levels down. And hence, any mistakes made during the prior economic expansion, the positive growth in inflation, is locked in. It doesn't drop out; you just add to it. So looking at all those pressures, you wouldn't want to guess zero on inflation and neither of those groups are doing so. I assume that we'll continue to repeat that pattern, that is, we'll make some mistakes on the upside, and we will not make the offsetting mistakes on the downside. Inflation numbers probably ought to come out somewhere, I would guess, a little below your 4%. My guesstimate would be 3-4%. I can give you the prescription that would double that in a hurry. And it might happen. I can't know for sure. But I think we're doing a reasonably good job. Furthermore, a lot of us got scorched in the 1970s and the very early 1980s from accelerating inflation, and voters still remember accelerating inflation. They don't like it. Hence, for another some period of time, we're likely to take those actions that will keep the inflation rate reasonably low.

Now on the real wage increase, we're not investing well enough in both human as well as, in our physical capital, so that productivity in manufacturing has improved substantially over the last decade, but total productivity has gone up only modestly. It is something on the order of 1% a year. Now we're beginning to see restructuring in the service areas. Service industries and improvements in productivity are coming along. So if we could provide the incentives necessary to increase the allocation of resources toward capital investment, I would be more optimistic than that 1.1%, but then I don't see the political will to do that. We always want to live it up now. We find an excuse to spend another \$100 million here, another \$1 billion there, another \$1.5 billion, and always the pressures are toward higher taxes that will eliminate even greater spending. So I think I would keep those real wage rate numbers pretty low until there is some evidence that we really are serious about improving long-term economic growth. And I don't think we're serious yet. I can seriously talk about it, but after spending eight years in Washington, I can tell you that's tough. We made progress. But there's been some backsliding recently, and it's very hard to reverse.

FROM THE FLOOR: Considering the policies that Japan has on protective trade barriers or on attacking markets outside of its own country, how would you combat that from the standpoint of the U.S. employer, considering your interests in free trade?

DR. SPRINKEL: Well, I spent a lot of time working with the Japanese in the eight years I was in Washington. In fact, I led the negotiations on the yen-dollar agreement

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from the U.S. side. Tommy Oba did so on the Japanese side. And we made major progress in opening up their markets, and that's what you're talking about. There was major progress made during the Reagan Administration, and the best I can tell, there's been major further progress by the Bush Administration, although I haven't been nearly as close to it as I was then.

Now we have to be very careful that the complaints coming out of our business executives are not primarily of the nature that they want to be protected so they can have a short-run gain. I heard a lot of that in the debate on the autos here, when all of the auto people went to Japan and now they're trying to get Japan to arbitrarily reduce its imports, even though the quality in many of their exports is excellent. We want to have a high level of flow of goods between us and Japan, and we do. It's our second largest trading country. Canada is our largest trading partner. Japan is second. We're not indifferent to what happens. The President has so far been very careful to not bow to each pressure coming from the business community to inhibit the flow of goods. Who gets hurt and who gets helped? Always keep that in mind. The people who get hurt are you and me, i.e., the consumers. When you restrict the inflow either through tariffs, quotas, or other devices, you can be sure that the price of those products and services go up and you, the buyer, gets hurt.

Now who benefits? Well the benefit goes to those companies and individuals that provide a competitive good or service. And I do not think we are justified in protecting our businessmen. I do believe we're justified in pushing very hard to keep their markets open so that we can compete both fairly and aggressively in their nation. Even though it's true that we can gain, even if they are unfair, we the consumer can gain more. It's much easier to sell politically, if you keep the pressure on keeping their markets open. The Bush Administration has done that. The Reagan Administration has done that. Is it perfectly open? No, and neither is ours. We may be the freest trading nation in the world, but we are a long way from a free trading nation. Even during the Reagan Administration, with the President firmly devoted to free trade, there was some retrogression. Now all the retrogression came about because the argument was that if you don't give the Congress what it is demanding, and of course, the business people were pressuring, then the trade problem will be even worse, because Congress will succeed in passing a bill that will be even more restrictive. Well, you know, when you backtrack, it's hard to regain the ground.

So I think our basic view should be, keep our markets open, don't shoot ourselves in the foot, by putting on tariffs, putting on quotas and other restraints. It's not true that we exported jobs during this period of massive increase in trade during the 1980s and up to now. We didn't export jobs abroad. As I told you, during the Reagan years, during that economic expansion, there was 19 million new jobs started. We're on the verge of some major pluses in trade with the negotiations among Mexico and Canada and the United States and many of the other Latin American countries want to join it. The gap provides another possibility if we can ever get past the hurdle of the protectionists in Europe wanting to provide undue protection to their farmers. We as consumers and voters, in my opinion, need to continue pushing our elected representatives to avoid protectionism and to push other nations in the same direction. So I am not attentive to business people who just want protection from foreign competition. They need that competition just as the consumers do. It'll make a more efficient market, in the long run, and will improve

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profitability. When business people drag their feet, and do not improve the quality of their products, vis-à-vis those produced abroad, they, of course, will fail. But we have good business people and they're capable of competing. Look at the fact that there's been an enormous growth in exports over the last decade.

FROM THE FLOOR: You spoke to the various income groups and the percentage of taxes they pay. What are your views on the related question of the distribution of income and wealth where there have been claims that that's much more disparate?

DR. SPRINKEL: Yes, we're just beginning to get some good papers out. The results of one study were published in *The New York Times* and in a recent issue of *The Wall Street Journal*. There apparently was a very significant shift toward the higher income groups owning a higher percentage of the total assets. Why the nature of the shift and trying to avoid mechanical mistakes that can make it appear as if all of it occurred in that sector are other issues, and those are what the debate is presently. There are good numbers coming out, and I think there was a movement toward a somewhat less egalitarian distribution of assets that began back in the 1970s, but continued through the 1980s. And it's something that Americans are concerned about, but we've got to keep in mind, doing something about it will inevitably make it even less likely that we're going to grow and raise standards of living. It's a choice we have to make. There are no easy solutions that I know of.

FROM THE FLOOR: Do you know enough about Ross Perot's economic desires to comment on what his election might mean for the economy?

DR. SPRINKEL: I know what his desire is, he wants to be President of the United States. But he also apparently wants to do it without telling us where he stands on any policy issue that I've heard debated so far. So he has not taken an issue to the best of my knowledge, and I've read a fair amount. I've watched him on TV and he's a very intriguing gentleman. He's been very successful. Anyone who can go from poverty to \$3.3 billion in his early 60s has a lot of ability. But that doesn't mean he knows what causes an economy to grow, and it doesn't mean that he has positions on all of the important economic policies as well as social issues that are coming down the pike. I heard him say recently that he was going to stay out of the headlines for the next month and decide where he stands on all of those important issues. And I'll be listening, when he does so. But he hasn't up to now. It would be unfair for me to criticize because he hasn't said anything. But I'll be listening and I expect that he will be talking up on those issues in the period immediately ahead. Yes, he's an able person. There are a lot of able people in this country. Where would he stand on the important economic and social issues? I do not know. Whether he's going to cut more on the democrats or republicans, I don't know until I see where he stands. And I don't know him personally. I can tell you one thing -- he has owned these companies, and I have talked to people who have worked with him and he's a tough cookie. He ran his business with firm control. Well, he's in for a rude shock, if he does get to Washington. He won't firmly control the U.S. government, I can assure you. You may try, we tried, but there are lots of reasons why you'd be lucky if you go in the general direction you want to go.

FROM THE FLOOR: I'd like to ask you two questions. One is, in this current presidential campaign there's very little discussion, if any, by the two major

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candidates, if you will, on the concept of the deficit. Perot, I think, has addressed that to some extent, and I've heard some economists who say that it's really not a relevant issue, I think, if I can paraphrase that properly. Other economists feel that it's a major issue. Could you comment a little bit on your views of the deficit and the implications for the economy? And the second question is just a personal thing I'd like you to answer. When we talk about capital gains credit, there was a good talk show debate on it the other night on one of the public service channels, and unfortunately, there was one question that was asked, and I didn't hear the answer to it because the show ended. The major thrust of the capital gains is that reducing the capital gains will provide more money for business to expand and so forth. The question addressed was that if you sell me some stock that you have bought from the next person, and had held it for a while, how does that, in fact, affect the particular company that has sold that stock and how does it get the money that stimulates the economy?

DR. SPRINKEL: Well, let's take the latter question first. As you can see, if the price of the stock goes up, this means that the cost of new capital to that company that issued that stock goes down. So that it will be able to sell additional stock or acquire additional funds through borrowing, at lower cost than previously, because of the expectation that the company is going to be doing well in the future, which is presumably why the stock went up. So rising stock reduces the cost of capital, and if there is any one thing more important than having a low cost of capital when competing both domestically and internationally, I don't know what it is. One of the real reasons the Japanese were giving some trouble for a while was they clearly had lower costs of capital for some time. This is no longer true, but it was true for some time. So I think that's the real answer to the question you raised. If you lower the cost of capital, you will have a great ability to compete for resources, production and output.

On the federal deficit, there's several ways of looking at it. Everybody is against the deficit, or almost everybody. But the question is, how do you resolve the issue? I care a lot how you resolve it. We have a very sizable deficit running \$350-400 billion this year. Apparently, it's coming in a little lower than the most recent estimate. And that's a lot. Now, arithmetically, if you look at it that way, you can say, well, there are two ways of reducing the deficit. One is to cut spending \$350 billion, and the other one is to raise taxes \$350 billion. And you might be arithmetically or even actuarially, indifferent, but as an economist, I'm not indifferent, primarily because there's one other relation that I am convinced is true. I thought it was true before I went to Washington; I'm absolutely convinced it's true after spending eight years down there. When you use the tax root, it doesn't reduce the deficit. It increases the size of government vis-à-vis the total economy. That is, more revenues lead to even more spending, and you end up with the deficit and a larger government and therefore, fewer resources in the private sector and also higher tax rates, which discourage productive activity.

So how do you go about getting the deficit under control? By far the most important thing is, it's extremely difficult to cut spending in Washington. I mean the cold war is over, and you can't cut defense expenditures, because Congress doesn't want to create unemployment in its backyard. Or the Secretary of Defense doesn't want to pull expenditures down as fast as others may want. So it's very hard to cut

spending unless you had an item veto power, maybe. The main thing is hold any growth to very modest proportions, that's the real hope. That will limit the rise in total spending. The reason is, if you don't limit spending, it's just going to get larger and larger, because you'll never be able to pull it down. We have practically never pulled down federal spending, and even in my lifetime, back in 1929, the government was just a few percentage points of the total economy. Now the federal government is up to 25% of the total economy. And if we continue to feed in tax increases to close the deficit, we'll be up to 35-40% of the total economy with everything that it implies for tax rates, as well as job creation in the private sector.

Now the existence of a deficit means that you absorb savings that are generated either domestically or internationally, that would be going into other forms of investment. When I was Under Secretary of the Treasury, one of the jobs I had, which I don't believe you'd mentioned, was financing that deficit. I probably presided until recent times over the largest increase in the federal deficit of any Under Secretary in the history of the nation, about which I'm not very proud, although the recent one probably had a bigger one. We had no trouble in financing that deficit. That is, the federal government is going to get its money. It has the highest quality rating, and although there are always little problems that come along, you can do it. But does that mean it's not painful for the economy? If you absorb large amounts of savings to finance the deficit, it means those savings can't be used to augment investment in human and physical capital. Therefore, I think it is important, that over time we gradually pull that deficit down, by slowing the rate of rise in government spending. Once you get the economy growing more rapidly, you generate a lot more revenues, and those revenues can be a major help in pulling the deficit toward zero, provided you don't let spending get out of control. So it's critically important from my point of view, to maintain discipline on federal spending growth. It hasn't been done in my opinion, over the past three years. Although we made some progress during the Reagan years, pressures are always to increase government. And I think such tools as a balanced budget amendment under proper circumstances, like item veto, will improve the probability that the rise in federal spending would be of moderate proportions in the future and less rapid growth in the economy so that government, as a percentage of the total economy, could go down.

So that's where I stand on that deficit issue. It's not exactly saying that the deficit doesn't matter. I think it matters a lot. But it also matters about how you propose to get rid of it. Because if you propose to get rid of it with big tax increases, in my opinion, you won't get rid of it. In fiscal 1990, we voted for a massive tax increase to get rid of the deficit. The deficit is bigger now than it was then and government spending has soared. That's not the first time that's happened. We got zapped once in the Reagan Administration on that same issue. Somewhere around 1983 or 1984, I've forgotten the exact year, we made an agreement with the Congress that it would cut spending \$2 for every dollar we increased taxes. We increased taxes. Government spending went up, it didn't go down. So once you get burned, you don't forget it. And therefore, getting the deficit down is important over time, but it's even more important as to how resources are allocated between the federal government, vis-à-vis the private sector of the economy, where growth and jobs occur, if you're concerned about growth, and I am.