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ECONOMIC OUTLOOK AND TRENDS

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The outlook for American business next year and in the longer run will be described by one of the nation's most respected and articulate forecasters. Dr. William Freund shares his unique perspective as chief economist emeritus of the New York Stock Exchange. He is a unique economist because he knows the practical world of business and finance as well as the world of research and academia.

MR. MARK A. TULLIS: I'm chairperson of the Product Development Section Council this year. This is the big meeting that the section participates in, so it's the one where we have the most input into the topics.

I'd like to introduce our luncheon speaker. We're lucky to have Dr. William Freund. Dr. Freund spoke to us three years ago in New York and received high compliments. Dr. Freund started with the Prudential after getting his Ph.D. from Columbia University, where he eventually ended up as chief economist at the Prudential. But for the past few years, he has been with the New York Stock Exchange where he was chief economist and now works on a regular basis. He also has an endowed chair at the Exchange and is the New York Stock Exchange Professor of Economics at the graduate school of business at Pace University in New York.

DR. WILLIAM C. FREUND: Mark has given me a threefold assignment. He asked me to talk about the short-term economic outlook, the longer-term economic trends, and then to say some words of wisdom about prospects for financial institutions, including life insurance companies. That's a very formidable assignment, Mark. I really should have a whole semester's course.

There's a fair degree of skepticism about economists and economic forecasters. And I know from a long professional career as a forecaster, how wrong forecasters can be. But I think I hardly need to say to actuaries that there is no choice about looking ahead, because that's what you do all the time. Every time, in fact, you make some product decision or any kind of financial decision—personal, or business—there is an implicit assumption about the future, and I happen to think it's better to make your assumption explicit even if you're wrong, rather than somehow leave it unexamined and implicit in the decision you make.

I know, also, all the jokes that have ever been told about economic forecasters. Someone once defined an economist as a person who wonders, if something works in practice, will it also work in theory?

Let me turn serious now and talk very briefly about what we call the short-term economic outlook for the next year or two. We've come out of a recession, the

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economists tell us that the recession of 1990–91 ended somewhere in 1991. I believe that the recession didn't really end until 1993, in terms of a host of measures that I follow but that I won't bore you with. Now I think it's very important to fix a number in your head, and when I talk to other audiences, I'm always reluctant to mention statistics, knowing how boring they can be. But I know statistics are not boring to you. On average, when we have emerged from recessions in the post-World War II era, the economy would grow by 6% per annum in real terms apart from inflation. That's been the standard, the average, and the typical rate of recovery.

In 1993, our recovery rate was 3%. It looks like in 1994, the growth of gross domestic product (GDP) might be around 3.5%, and I heard today that the first quarter GDP, which was expected to be down because of bad weather throughout the country, because it played havoc with the seasonal adjustments, was up at an annual rate of 3%, higher than expected. So there is some momentum behind the expansion, but it is certainly not up to the rate of recovery that we've become used to. So, 3% recovery per annum might not seem like much compared to that 6% average, but right now, 3% growth means moderate inflation. And a faster pace of growth would mean an accelerating rate of inflation. The chairman of the Federal Reserve Board, Alan Greenspan, testified before a Congressional committee, and expressed continuing concerns about the economy, even though it is only growing in the neighborhood of 3–3.5% per annum, perhaps this year. He made the point that it may be necessary to tighten monetary policy a notch further before the year is out if there are signs that the economy will accelerate beyond the 3% rate.

I have believed for weeks that it is the intention of the Federal Reserve System to contain the rate of economic expansion to 3% and to keep that rate going for several years and not allow the escalation of expansion that we've become used to in post-recession periods. The Federal Reserve has simply concluded that, if we were to grow faster, we would use up our excess productive capacity too fast; the unemployment rate now at 6.4% would drop below 6%; and we would get price pressures from both the wage side and the industrial capacity side which would not be acceptable to the Federal Reserve.

And so the name of the game is contain the expansion to 3%. That's a number you need to watch in the future, and I think the Federal Reserve will succeed. Interestingly enough, the Clinton Administration is going along. There has hardly been a word of protest from the White House, even though we have now had a 1.25% rise in very short order, in the federal funds rate. And the reason, I think, is simply this; the re-election campaign of President Clinton will begin in late 1995. It is not all that far along. And if we know anything, it is that incumbent presidents lose if we are in a recession. And so, to avoid the spike of economic activity followed by a drop in an election year, the Federal Reserve's action has almost been welcomed at the White House as a way of extending the expansion for years to come. In fact, I've examined this record of incumbents losing in recession years. Of course, President Carter is a prime example. He lost in a recession, although he probably would have lost anyway. And then there was President Eisenhower, who was a case all to himself.

I believe that the same factors that slowed recovery will now extend the expansion for years to come. Let me just run through a number of factors that I think have served to moderate the expansion this time. Why haven't we grown at 6% a year since the recession ended? I have come up with five reasons why I think we have not grown. We've grown at half the usual pace. And in order to understand the future, I think it's important to understand these five factors. Let me cite them very quickly.

In past recessions, we saw temporary layoffs. Blue collar workers lost their jobs in the steel, auto and construction industries. When the recession ended, the blue collar workers would be recalled. But now, on top of that, we have had substantial white collar layoffs to achieve efficiencies. We call it downsizing and streamlining and restructuring. Whatever you call it, the fact is, that this has been a different employment situation than in other recovery years. Now, however, I need to alert you that employment is picking up. We still get the headlines of the big companies laying off and downsizing, but we don't get headlines about the hiring that's going on primarily in medium and medium-to-large-size firms.

In 1993, we created two million net new jobs in the U.S. And that trend, if anything, is continuing and accelerating. And many of these jobs, by the way, are professional jobs. It is simply not right to characterize all the new jobs as hamburger flipping jobs. So the employment news is beginning to improve, and I also believe that companies cannot continue to hollow out their staffs indefinitely as they have been doing.

The second factor that has served to give us a relatively modest recovery and that I think now will extend the expansion is that we were suffering the hangover from the 1980s. We will pay the penalty for that era of borrow and spend. And not only was the federal government borrowing as if there were no tomorrow, but corporations also were borrowing largely for mergers and acquisitions (M&As) for the leveraged buyouts (LBOs), and they accumulated such large volumes, such large amounts of debt, that they had to tighten their belts.

Now, when you look at the numbers, corporations are in a much better financial position to expand, and the M&As that are now taking place, and they are increasing again, are being financed not by debt, but by equity.

And then there was the consumer who also borrowed up to the hilt. The consumer tightened his/her purse strings, and now consumers look a little better off. Also, consumers found out that they couldn't defer purchases forever. For example, the automobile market is booming. And the reason is that the average age of an automobile in the U.S. is eight years old! There comes a time when you simply have to replace that old clunker. That's what consumers are doing and it is giving a lift to the economy.

The third factor that's slowed us up, in my opinion, was the overbuilt real estate. You, in life insurance, know this as well as anybody. Offices and shopping centers had large vacancies. We stopped building since about 1990, and we are beginning to absorb some of these excess vacancies. And in many places, brokers and landlords are saying that the real estate recession is ending.

The fourth factor that slowed us up is the end of the cold war. And the large defense cutbacks that we are seeing (15% of the layoffs since 1990) have been due to base closings and defense cutbacks. The fact simply is we no longer fear the Russians. Their GDP is down 30% in two years. They're suffering from hyperinflation of 20% a year, and they are engaged in a race between reform and chaos.

The fifth factor in the slow recovery has been that, while we were beginning to emerge from recession, Europe and Japan went into a recession, with the result being that their demand for our exports dropped. Now the bottom is in sight, apparently. Germany and probably Japan will begin to inch up, which would help our exports.

It seems to me these five reasons: the permanent layoffs for efficiency, the hangover of debt from the 1980s, the overbuilt real estate, the defense cutbacks, and the recession overseas have made for a slow recovery. And these forces are now losing their punch. In fact, the headwinds are calming, and that's why the Federal Reserve is worried about excessive expansion and wants to extend the expansion. Bear in mind, too, what Alan Greenspan said in his testimony. There is a lag in monetary policy of 9–12 months between tightening interest rates and the effects on GDP. So the Federal Reserve, in fact, does have to take preemptive strikes that it has to anticipate. It is not enough to look at coincident indicators, and to act. You have to act in anticipation. And of course, the Federal Reserve's aim is not to tighten too much, so as to precipitate a recession, and I think its aim specifically is to keep this expansion going at a rate of no more than 3% per annum. I think the Federal Reserve is on the right track and as Greenspan said, "We may, in fact, as numbers begin to emerge in the balance of the year, if the momentum remains as strong as it appears, get another half point rise in short-term interest rates." And that, I think, will keep the expansion to the level I've indicated and keep inflation in the 3–3.5% range.

It was Winston Churchill who once said, "In the end, Americans always do the right things. After they have exhausted all other alternatives." A word about the stock market and its volatility. Clearly we've been through a very long bull market. Regarding price/earnings (P/E) ratios, any of the standard technical indicators seem to indicate the market's relatively high. P/E ratios are high. The price-to-dividend ratios are high, and so after a few years run of a bull market, 5–10% correction is certainly not unusual. What I was impressed with this time, is that the mutual fund public did not panic. This is unlike October 19, 1987, you may remember, when we had the last real price collapse. That was when there was a rush to exit.

The fact is, that I don't know what the stock market is going to do next week or next month, and I'm not sure anybody else knows. But I must share with you some thoughts about the longer-term trends in stock prices that I think may be of interest and importance to you. Investors in stocks, over decades, have viewed stocks to be yielding 10%, 11%, 12% per annum. And that's what they did yield. And they yielded that much compared to bonds, because stocks were perceived to be risky. And so investors demanded a risk premium, and the risk premium was for risk aversion, as economists call it. Maybe actuaries do, too. And that risk premium, the academics have calculated in the neighborhood of 6.5% for stocks over bonds.

It seems to me, that risk premium has shriveled. A whole new generation of investors have come into the market; insurance company investment managers, pension fund managers and mutual fund managers with very little historical memory. And, they have simply become convinced that the risk in stocks has diminished and therefore, that the risk premium also should shrink. I believe this risk premium has shrunk and is no longer anywhere near 6.5%. And these managers have done it obviously by bidding up the prices of stocks. And that's why the indicators for P/E ratios and price/dividend ratios are so high.

Now that doesn't mean, to me, that the stock market is about to have a huge collapse; I don't believe it will. But that you ought to anticipate an over-the-decade lesser return from stocks. It may be in the area of 7% a year, rather than 10% or 11% or 12% a year. Now that probably still makes stocks attractive relative to other fixed-income investments, but not as attractive as stocks were at one time, and you ought to bear that in mind in your own planning. So much for the short-term outlook and some other comments I've made.

Let me now focus on longer-term trends and then on some financial developments. I tell my students that it isn't all that difficult to make projections longer term. Not only because the forecaster probably won't be around, but also because essentially there are two factors that determine a country's longer-term economic growth. The first is the number of people at work, the labor force or the growth in the labor force. We know the labor force will grow more slowly because the baby boom generation, like many of you, joined the labor force years ago, and the next generation coming along, of course, is the baby bust generation. Need I tell that to actuaries and demographers?

Furthermore, women have already been absorbed into the work force, so we don't get this big explosion in female labor force of participation, to use the economic term. Increasingly, we will have to rely for economic growth on the second factor, which is productivity growth. And when I mention productivity growth to students, their eyes glaze over with boredom. They somehow think it is an abstraction concocted by economists, but you know that it's real. By productivity growth, we mean output per person. We mean efficiency of production. We mean unit labor costs. Choose your definition. In the end, it is productivity growth that determines the nation's economic growth. And it determines whether and how much our standard of living rises over the decades.

We used to pride ourselves, in the U.S., on a productivity growth rate of 3% a year. That's what we had in most years during the 1960s and 1970s. Some years it was less, some years more. But it was an average growth of 3%. That's what made us a dynamo, an international competitor par excellence. That's what gave us our rising living standard. Then in the 1980s, somehow we lost our way as productivity growth dwindled from 3% to 2% to 1% to 0. In fact, it was some years ago, that I recognized that this was the area where American companies would have to excel in order to remain a first-rate economic power. I coauthored a book with Eugene Epstein, called *People and Productivity* (Homewood, Ill.: Dow Jones Irwin, 1984) and I said it was an essential priority for the American economy. The fact now is that one of the best kept secrets in America is the resurgence in our productivity growth. There have been major improvements in productivity growth in manufacturing. Managements have been shocked into action by tough new competition, which is now, of course, highly global, highly international. And as a result, American firms have cut fat. They've lowered their break-even points. They are responding to the heat of competition. They've become very aggressive. Recent statistics show that in manufacturing, our productivity growth has risen 4% a year in the last four years, as we have restructured, as we have slimmed down, as we have undergone industrial rejuvenation. In 1993, the rates went down 6.5%. They went up 6.5% in Japan, and 4.2% in Germany. These are annual rates. So many foreign companies, including foreign automobile manufacturers, are coming here to build and assemble cars because of our mounting productivity.

In a quiet revolution, the U.S. long derided as an industrial has been, and is now one of the world's low-cost manufacturers. Taking place before our eyes, is now the same kind of slimming down, or rejuvenation in the services industries that we've seen in manufacturing. We talked at lunch about how insurance companies have streamlined and cut back. But it's not just insurance companies, it's banking, it's brokerage, it's legal, it's health care. The whole gamut is involved, which will pay longer on dividends. I think in the service industry, it's largely computers and management that have made it possible. At the outset, when we first had computers, I think we used them largely to send memos to each other. And now we've learned to engage computers in the service of productivity gains.

The Europeans know it. The *Financial Times* of London wrote just a few weeks ago, "It will not be long before people start talking about a productivity miracle in the U.S." And the *London Economist* said earlier this year, "American firms are looking slimmer, fitter, and further in front than ever." I can tell you that October 19, 1987, the New York Stock Exchange was held together by spit and glue. There were 500 million shares barely done that day. Today, with fewer people and no more floor space, the New York Stock Exchange can handle one billion shares a day on a sustained basis. And you could cite any number of industries where sophisticated computer "processing" has made that possible. It is time to recognize America's strengths. We've become the envy of the industrial world. We are, again, the world leader. The only place where people don't recognize that yet is right here.

I was going to spend a little time on the importance of education in this scheme of things. I'm going to have to skip that in the interest of time, but suffice it to say, that this new kind of rationalized production and servicing requires an educated work force. The jobs for illiterate people, for unskilled and untrained people, moved offshore long ago, and we cannot compete in labor-intensive industries where unskilled workers are required. We need to survive and compete in the world economy. We need workers who can operate computers, who can analyze data and read and understand complicated instructions. I was at the McDonald's the other day, and I saw a cash register with no dollars and cents. It had french fries, hamburgers, and cokes on it because, presumably, the cashiers didn't know how to handle dollars and cents. That won't fly in the future.

Our competitors are better educated. We know from standardized tests, for example, that the typical Japanese high school student is far better educated than the American high school student. In standard tests in math and in science, we still do better in English. It is clear to me that we can remain a first-rate economy only with an improved educational system, and I'm delighted to say that more companies are recognizing that and taking a role in it.

Finally, I come to the third part of my presentation, and that is some reflections on trends for the financial industry and financial institutions. Let me just tick off a few observations. You might think some of them may hold water and you may not agree with others. These are some things that occurred to me as I thought about the subject.

I think we are beginning to see less identity for financial institutions. And financial institutions will be less known as banks and insurance companies and brokers and investment bankers. For example, our commercial banks, which have suffered an erosion of market share, are in mutual funds, and they are in investment banking, and they are in credit card processing. And they are in insurance, probably more so in the future as regulations change. They are in risk management. They are in asset management. That doesn't mean every bank does that. There may be specialized banks, as there are, but the banking system, as a whole, is in all of these activities.

Second, all financial institutions will be operating in an increasingly global marketplace with a multicurrency payment system. I'm not talking out of turn when I tell you that there are plans at the New York Stock Exchange to trade foreign stocks at the outset, not just in dollars, but in foreign currency. For example, why shouldn't Daimler Benz, which recently was the first full-fledged German company to list on the New York Stock Exchange, trade its stock in dollars as well as in German marks? And one of these days, you'll see that happening.

My daughter is an investment officer at TIAA. Some of you may have heard of that small insurance company. She is flying to Australia for due diligence test on an Australian loan. Only a week later, she will be flying to London for due diligence on a British loan. Lending has become global, particularly so since private placements in the U.S. appear to be diminishing. Obviously, everything in the financial service industry will be in book-entry form.

I believe, too, that the financial companies will be inhabited by some of the most creative people. In addition to actuaries, people with training in science and in math, will employ such esoteric techniques as chaos theory and fuzzy logic and intelligent systems, none of which I understand. I am right now engaged in a research project on the efficiency of pricing of the Toronto Stock Exchange, before and after automation. The Toronto Stock Exchange is giving up the floor to be fully automated, and I'm studying the efficiency of pricing using chaos theory because linear relationships simply don't show what has happened. And as this happens, you get these very creative people aboard, you'll see changes in management. You're seeing it in Wall Street. Firms like Goldman Sachs have lots of quants, they call them, who are high-powered, mathematical, scientific types, many who are from the universities. And they have been responsible for generating hundreds of millions of dollars of profits, through new techniques and new products, based upon these studies.

So I expect a flattening of hierarchies, as this happens. I believe too, that we will see an increased use of derivatives. We hear a lot about the volatility of derivatives, and in fact, there were just hearings recently at the Congress, but remember, that derivatives were developed as a method for reducing risk, not for increasing it. And I think we will insure against all kinds of risks.

We'll see new means for all kinds of financial risks. We'll see new means to maximize returns and minimize risks. I look for the continued securitization of financial instruments. You know, we now bundle mortgages. We bundle all kinds of assets and liabilities into financial instruments that can then be traded together. And it has been found to be very efficient, and reduces costs tremendously. But why wouldn't it be possible to securitize insurance claims the way we did with mortgages? I'm sure some innovative, creative, financial wizard will come up with a way.

I look for disintermediation to continue. Instead of borrowing from a bank, hundreds of Fortune 500 companies are no longer engaging in private placements. They are borrowing directly in the financial markets, using their IOUs. This is one reason why my daughter is off to Australia and England.

I would like to end on an optimistic note for insurance companies. If you look at the share of assets of financial institutions, a share in the total financial markets, you'll find that between 1980 and 1993, the share of the commercial banks has gone from 35% down to 25%. That is considerable erosion. For insurance companies, the ratio has gone from 16% to 17.5%. So you must be doing something right, and I also think that there are favorable changes in demographics ahead. There is a large new market for life insurance and pension products, coming from the baby boomers, who are now entering middle age. Their peak savings ages. And also, I believe, you will benefit from social policies, which will increasingly favor a shift from publicly provided pensions to private ones.

That's all the wisdom I had on financial institutions. So let me say in conclusion that I remain reasonably optimistic about the American economy, in the short term and longer term. The world isn't coming to an end for America. You know what Will Rogers said about the world coming to an end. He said, "If the world comes to an end, I want to be in Cincinnati." He said, "Everything happens there ten years later." I recognize we have problems in our economy, maybe I have not emphasized them enough. We still have a large federal budget deficit. We still have a lot of poverty. We still have a lot of ignorance in our educational system. We are still plagued by high levels of public and private debt. But we also have a resilient society that has responded to the challenges by an upsurge of productivity growth. I find that fact immensely reassuring.

Now I know that productivity growth doesn't happen by itself. It is people like you who make productivity grow. But I believe that we are just on the verge of some great new technology. In fact, I have thought that the burst of technology today is as important in our economy, as the emergence of the railroads in the 19th century and the automobile in the 20th century, in terms of not only computers, but also the whole field of communications.

We remain, I think, a land of opportunities. We ought to shed some of our unrealistic pessimism in this country and regain our confidence, for we possess real economic strengths waiting to rise to the surface. We have, I believe, unprecedented potential for longer-term growth and for international competitiveness.

FROM THE FLOOR: This is a question partly for the audience of actuaries. We had a record entry of married women into the work force in the 1980s. Now it has stopped. This is not meant to be a derogatory or sexist remark. Those women were inexperienced, and they couldn't exhibit high productivity. They had to keep the average productivity down, while entering the work force. And in fact, we had a policy at that time of encouraging the availability of as many jobs as possible, regardless of productivity. The tax laws encouraged that and that was the result. Right now those women are not entering the work force, and in fact, the Federal Reserve partly, as you pointed out, is not encouraging great growth. I think these two factors greatly contribute to lower productivity growth in the 1980s. It is higher now. They may even explain it.

DR. FREUND: I'm not sure how to respond to that question. I want to stay out of trouble. I think you're probably right, that as women streamed into the work force in the 1980s (and that's when it happened, beginning in the early 1980s), they were inexperienced, and they were also held back because they were offered entry-level positions. The result was that they may have contributed to some part of the slowdown in productivity growth during that time that I mentioned. I think that's behind us. I think the women who are now well-established in the labor force have far higher, greater opportunities to show their skills and to advance. Witness my daughter, who is a very senior official at TIAA. Do you think she would have had those opportunities in the 1960s? Probably not.

FROM THE FLOOR: How do you view China and the growth of the Pacific Rim?

DR. FREUND: I think China is such a complicated question that nobody could give an informed, complete answer in a few minutes. We know that it has been growing at 10–15% in real terms in recent years. It has been a phenomenal story. The fact that may surprise you is that, despite political repression, two-thirds of the Chinese economy is now privatized and is working on the basis of incentives. And I must tell you that I have a theory. It's purely a theory. It has not been proven, and I may well be wrong. It may be that it is too difficult for a country to establish a privatized market system at the same time that it establishes a political democracy. That may shock you. But I think one of the problems in Russia is that it is struggling against overwhelming odds to establish political democracy in some way, at the same time that it is moving towards a system of capitalism. And that may well be responsible for the chaos we are seeing there and not in China. The jury is really out on China. Undoubtedly, it will continue to grow, probably not as fast as it has because it has to restrain inflation there, too. It has been growing so fast that it has used up much of its resources too fast. It depends, of course, on what happens to the Premier, and to China's political system, and whether the country embarks on a whole new era of extreme repression.

I think China has a better than even chance to make the transition to a market system, certainly a far higher chance than Russia does. If China makes that transition, there's no question it will be one of the great growth areas of the world. There are some people who are saying that the GDP of China will exceed that of the U.S. by the year 2030. I don't know if that's true, but it's just a manifestation of the optimism that pervades in many places about the growth potential. All of Asia is growing rapidly. If you have an opportunity to participate in it, you should.