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THE U.S. ECONOMY IN TRANSITION

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The American economy is finally flexing its muscles once again. There is a renewed feeling of business and consumer confidence. Even the automobile industry is experiencing stronger sales and some laid off workers are being recalled.

American families across the nation are feeling that the worst may be over. About two million new jobs were created so far this year. Incomes are rising and department stores are reporting a strong increase in traffic, and even sales of hard goods like furniture and appliances are improving. Consumers are seeing their purchasing power suddenly increase as the massive federal tax cut takes hold and as inflation continues to stay low.

Signs of life are evident in the depressed housing industry. Builders and real estate developers are telling us that homes are selling well after three disastrous years. Mortgage lending institutions are now flush with funds and are actively seeking well-planned and sound construction projects. Home prices have, mercifully, stabilized and mortgage rates have fallen enough to create an incentive for people to buy. Housing starts are now about 70 percent ahead of a year ago and further gains are likely. All this is in sharp contrast to a few years ago when financing had literally dried up, and high interest rates and home prices literally suffocated the market.

Some people tell me that this recovery is healthy in the sense that it is proceeding at a slow and manageable pace. I agree. It would be far more dangerous at this stage if we had too rapid a growth rate, because that would inevitably cause the economy to overheat and push up inflation and interest rates.

It should be pointed out that this recovery — like all others — is centered on consumers and not on capital investment. This will come later — most probably before the end of this year or early in 1984. Businesses in general, are not yet too anxious to increase their spending on new machinery or new plants. There is still too much excess capacity and the backlog of orders is still small, especially in such industries as steel, chemicals, energy, commercial and industrial construction, and other capital goods industries.

In agribusiness, the recession is still not over. Most surveys of business plans for future investment spending indicate that growth will be moderate this year. The exceptions, of course, are in high technology industries, such as computers, and in defense-related activities, which have been very strong especially in California.

So, the recession is over, and we have a full-fledged recovery in progress. However, before we celebrate we should ask ourselves what we have learned from recent events. For, unless we know what happened, we might make the same mistake once again. We have learned, for example, that a high rate of inflation, accompanied by excessive government spending will eventually lead to a financial crisis. We also learned that overhead costs and expenses rose too rapidly in the private sector during the boom of 1976-1979. In addition, corporations were too quick to raise prices and grant fat wage increases without a commensurate increase in productivity. We also learned that the world economy cannot fully shrug off the effects of severe shocks like the energy price increases of 1974 and 1979.

As it turned out, the recession which ensued was the worst in nearly 50 years. It was long and pervasive; very few industries were spared. The human impact was very high with three million jobs lost and an unemployment rate close to 11 percent. Meanwhile,

- business profits fell 27 percent.
- bankruptcies more than tripled.
- housing starts skidded 60 percent.
- car sales plummeted 40 percent.

Why has this recession been so long and severe? This brings me to the main theme of my talk today and to the message I have for you. *Basically, it is that America is undergoing change of a fundamental nature.*

In America, as elsewhere, changes are going on at all times in the economy. We have always prided ourselves in being able to adapt rapidly to them. This is one of our strengths and it has enabled us to rebound from adversity. Indeed, it is said that corporations or individuals that do not change with the times are often left behind. In the words of Sir Winston Churchill: "To improve is to change: to be perfect is to change often."

Cyclical Changes

Cyclical changes take place at fairly regular intervals and are quite normal. They are also of a temporary nature. For example, we know from experience that America goes through a recession every four or five years and that it lasts around eight to 12 months. Such ups and downs in the economy can even be healthy for it is precisely during such difficult times that management and labor roll up their sleeves and get the economy moving once again.

The resulting improvement in productivity is part of what I call the self-corrective mechanism which is basic to our economy, and which doesn't exist in other economies that are more rigidly controlled by the government.

Structural Changes

During a recession, the cyclical problems that confront a business are quite serious. But when structural changes take place at the same time, then the problems deepen and intensify. At present, many key industries in America are going through severe structural changes which have had a major effect on sales and profits.

The most visible example of structural change was the sharp increase in oil prices in 1974 and again in 1979. It is a sign of the times that our economies suffer when prices go up sharply and also when they go down. This, and other structural changes of the last decade, have permanently and fundamentally altered the nature of doing business in virtually every single corporation in America. It is sometimes hard to believe that we are living in the same world as we were ten years ago. Today's world is one of stiff competition, extensive deregulation, worldwide malaise, and extreme uncertainty. It is one of mergers and divestitures.

Corporations which in the past were locked into a competitive struggle for survival have now joined forces. Conversely, large conglomerates have been broken up into smaller companies that are now competing fiercely against each other. In today's world GM owns 40 percent of Isuzu, Ford 25 percent of Mazda, Chrysler 15 percent of Mitsubishi, and Renault 50 percent of AMC.

But nowhere are these changes more apparent than in financial institutions. Banks, savings and loans, insurance companies, brokerage houses, department stores, and others are all entering new horizons, partly because of deregulation and the breakup of 50-year-old laws. There is a new and powerful philosophy taking place in business America today and it goes like this. Why can't I diversify and expand my business into other areas? Who would have predicted that today one of the nation's largest insurance companies would also own one of the largest brokerage houses or that the largest retailer would be into securities, homes, insurance, and banking?

Deregulation and structural changes are also affecting key industries such as transportation, communications, travel, broadcasting, and energy. And just a few months ago the administration announced it is considering eliminating or modifying the nature of farm marketing orders for certain farm commodities, especially citrus. In each of these industries, deregulation is causing massive changes that are leading to a complete internal restructuring.

Beyond deregulation, other structural changes are also affecting our economy. The new bankruptcy law of 1978 has greatly increased personal and corporate bankruptcies, resulting in heavy losses in consumer credit and loans to small businesses. Of similar importance is the new monetary policy adopted by the Federal Reserve in 1979, which has emphasized control of the money supply instead of interest rates as a means of curbing inflation.

This policy has caused interest rates to become much more volatile and to stay at historically high levels. Aside from curbing inflation, this strong medicine also was necessary to counter another structural problem — the huge budget deficits arising in part from Reagonomics and the massive tax cuts.

The key issue facing America right now is whether, under these circumstances, the economic recovery is sustainable. Will this fledgling recovery survive and grow even stronger? We are optimistic that it will. Our optimism, though tinged with caution, reflects the following positive developments.

- The inflation rate is low. What's more, it will remain low even into 1984. Reasons include a strong dose of monetary discipline, relatively large food supplies, bumper harvests, reduced wage demands, stronger competition, a world oil surplus, and a strong U.S. dollar. For this year and next, we expect consumer price inflation to average around 3 percent to 5 percent, which is less than half the rate only two years ago.

- Another reason for optimism is that there has been a sharp reduction in inventories as a result of substantial improvement in sales in many industries. Another reason is the concerted effort by businesses to cut excess inventories through extensive discounting and sales promotion. Inventory cutting has been particularly successful in the auto industry where generous price markdowns and lower interest rates helped auto dealers reduce their stock of 1982 and 1983 models. With their shelves now nearly bare, stores and corporations across America are rebuilding their depleted inventories, which has helped get the economy moving again.

- Interest rates have fallen substantially. In early 1982 short-term interest rates, as measured by the banking industry's prime rate, was 16.5 percent. Now it is down to 11 percent. Long-term rates also fell reflecting, in part, the improvement in inflationary expectations and the increased availability of funds. Additional moderate declines in interest rates are expected in the months ahead.

- Consumer and corporate balance sheets have strengthened. The average consumer is no longer as heavily in debt and short of cash, as in the years 1978-1981. The consumer debt burden as a proportion of disposable income has fallen to about 15 percent, the lowest in two years and well below the peak of around 17 percent reached in 1980-

81. Consumers are thus in a better financial position to increase their spending, especially since confidence levels are improving.

- Similarly, corporations have restructured their balance sheets by replacing expensive short-term loans with cheaper long-term debt. Also, they have postponed capital expenditures, and generally cut costs at all levels of activity, and, in so doing have raised productivity. In many cases, corporations have also sold assets in order to improve their cash flow and to prepare themselves for growth should this recovery show more promise.

Risks Ahead

Still, it's quite clear to everyone who follows business trends that this recovery is fragile and spotty. Despite all the positive signals we are now receiving, there is concern that this may well be a false start and that, as in 1981, the upturn will fizzle out as we enter 1984. Accordingly, many corporations and consumers are still on the sidelines waiting to see if this year's improvement will be lasting. Such skepticism is well founded, for two major threats to recovery remain: the ballooning of the federal budget deficit and the dangerous international financial situation.

The government deficit is clearly the greater threat to the economy, since it practically guarantees that it will be difficult for interest rates to decline much further. The fact of the matter is that real interest rates at this stage of the recovery are about twice as high as they should be. Our feeling is that a further decline in rates will be needed if the present improvement in the economy is to be sustained. The Federal Reserve is deliberately holding fast to its policy of high rates to convince Congress that the budget deficit must be reduced before rates can come down any further.

On the international front the problem is really twofold. First, the worldwide recession and the strong dollar have seriously weakened our exports. Indeed, in 1982 our trade deficit totaled \$43 billion, and early estimates for 1983 place it at \$60 billion to \$70 billion. It should be remembered that export markets account for around 10 percent of the nation's economic activity. Second, the international financial system will continue to be severely strained by the large volume of foreign loans. Some of these loans are in the process of being rescheduled to allow debtor countries, hit by falling prices of oil and other commodities, more time to improve their financial situation. In that context, lower interest rates would greatly reduce the debt burden and facilitate the recovery process. For example, a one percentage drop in interest rates would save Mexico \$700 million in interest payments. Conversely, a \$1 drop in oil prices would mean \$500 million in lost income.

The bottom line is that the American economy will most likely continue to grow in 1984 but not at its usual potential, reflecting, in part,

the structural changes mentioned earlier. In time, however, the recovery will broaden and strengthen. With inflation remaining low, interest rates will edge down a little more later this year. For many businesses, profit margins are already starting to increase, reflecting some gains in sales and in improvement in productivity. Similarly, many American families are realizing that the worst may be over and that conditions will improve in the course of the year.