Outlook for the 1990s and Beyond

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The 1930s was a watershed decade, during which many countries moved away from reliance on markets to solve economic problems toward greater reliance on government to solve problems. During that decade, governments throughout the world greatly increased their intrusion into such decisions as what one could produce, where one could produce it, how much one could charge for it, how much one could pay labor, what interest rates one could pay on deposits, what interest rates one could charge, and how much of one's earnings one could keep.

The 1980s was another watershed decade for intellectual opinion about the proper role of government in the economy. During that decade, the failure of central planning and government intervention to solve economic problems became evident. That failure was exemplified by the collapse of Communism in Eastern Europe and eventually the former Soviet Union. In much of the world, the trend now is toward increased use of market mechanisms to solve problems. This change in the intellectual climate has very favorable implications for the United States in the 1990s.

At the outset, I want to emphasize that government incentives and programs are not necessary to spur economic growth or to achieve full employment. The underlying sources of economic growth are increases in the size and skills of our labor force, and increases in the stock and productivity of capital. Moreover, the economy has a natural tendency to move toward full employment of its workers and capital because of the self-interest of workers and investors.

Government actions can, however, hamper full employment and growth. I won't elaborate here, but there are many ways in which taxes, regulations, and inflation hamper private sector efforts to plan, to invest, and to produce. The appropriate role of government in the economy is to provide a stable monetary, fiscal, and regulatory environment within which private market forces can operate. Pursuit of that goal is the best way to foster prosperity. In the area of economic policy, the government's motto should be to "do no harm."

Given the media focus on current events, it is easy to overlook the fact that some positive, basic forces that are already in place will affect the U.S. economy during the decade of the 1990s and into the early years of the next century. Interestingly, some of the underlying forces that will shape this decade are markedly different from the forces that helped shape the 1980s, and overall these differences suggest increased economic prosperity as we enter the next century.

Although both the 1980s and the 1990s began with international crises and national recessions, the similarities end there. As will become more clear, I believe that the remainder of the 1990s will be much different from the last decade. Every period is unique, and those who expect this expansion to be like the last one are like generals who make the mistake of thinking that the next war will be like the last war.

Thinking About the Future

We are in the midst of a national election campaign, and there is a natural uncertainty about how the outcome of the election will affect future government policies. Fortunately, many of the important forces and trends that will affect the 1990s are in place and will not be affected by the election's outcome. These are the forces and trends that I will discuss this morning.

In thinking about the future, it is important to recognize the dominant or fundamental forces that will influence the intermediate outcomes that, in turn, determine long-range outcomes. Some dominant forces include demographic trends; government policies in the fiscal, monetary, and regulatory areas; and international conditions, such as developments in foreign economies, oil prices, and exchange rates. These forces influence certain intermediate outcomes, such as employment growth, the inflation rate, interest rates, trade balance, saving rates, capital formation, and productivity growth. While people in business, as well as economists, devote much attention to near-term outcomes, the outcome that we really care about is the standard of living. [Exhibit 1]

Forces and Trends That Will Affect the Future

The Labor Force Will Grow More Slowly

Demographic trends will affect the economy, regardless of government policies. Take, for example, the labor force. Some individuals start work after high school, and some start after college. So, at about age 20, plus or minus a couple of years, individuals enter the labor force. Therefore, we can be fairly certain about how many people will reach working age during the next 20 years by just looking at the numbers of births during the last 20 years. [Exhibit 2]

The birthrate of the post-World War II baby-boom generation reached its highest levels in the period 1957 through 1962. Individuals born in those years reached working age between 1977 and 1982. Indeed, the labor force grew sharply throughout the 1980s because of the baby boom.

In the 1970s we had what some call a "baby bust," a dramatic slowdown in the birthrate that is reducing the number of entry level workers in the 1990s. More than five million fewer people will reach age 20 in this decade than in the 1980s, a 14 percent decline. Over the next four years, the shortfall from the average of the 1980s in the number of new entrants to the labor force will be nearly 20 percent. Immigration also augmented labor force growth in the 1980s, but there is no reason to believe that immigration will be any greater in the 1990s.

The shift from rapid to slower labor force growth will have important and lasting effects on the economy. For example, the labor force boom of the 1980s tended to pull down the average experience level of the work force. It also tended to hold down the amount of physical capital that each worker had available to work with. Both of these tendencies constrained growth of worker productivity, that is, the increase in output per hour worked. In the 1990s, the slow growth of the labor force should both boost the average level of experience and make it easier to increase the amount of equipment per worker, thereby speeding the growth of productivity.

In the 1990s, the reduced number of entry level workers will coincide with an abundance of experienced mid-career workers. This trend is likely to narrow the gap between entry level wages and mid-career wages, which will be a challenge for salary administration.

The composition of new entrants in the work force in the 1990s will be different from the stereotypical, American-born, white male. Additions to the labor force will include large numbers of women, minorities, and immigrants. Moreover, the Americans with Disabilities Act, which went into effect in July, could further change the composition of the work force. So, while the challenge of the 1980s was to absorb the very large quantity of new workers, the challenge of the 1990s will be to respond to the changing composition of the labor force. For example, how will businesses deal with a large increase in the number of workers for whom English is not their first language?

Demographic trends will also retard the growth of consumption and increase personal saving. Baby boomers came of age in the 1980s and needed a first home, furniture, cars, and credit to finance these purchases. The number of people who will come of age in the 1990s will be smaller, so there will be less demand for initial housing, furniture, and cars, and therefore less borrowing. At the same time, the baby boomers will be reaching a higher age bracket, which implies that their income is likely to rise relative to their consumption and they will save more.

Productivity and Worker Skills Will Improve

Productivity growth will be more rapid in the 1990s than in the 1980s. Admittedly, productivity growth is very difficult to measure, and it is becoming more so as the composition of output shifts from items that are adequately measured in such units as bushels, tons, and square yards, to goods and services that embody quality improvements that are very difficult to measure. Regardless of these difficulties, there are forces at work that should augment productivity growth.

I already mentioned that slower work force growth will boost the experience level of the work force and facilitate increases in the amount of physical equipment available per worker. In addition, the reduction that I expect in defense spending should free resources for greater private sector investment. Another boost to productivity in the 1990s will come from more effective use of the large investment in information technology made in the 1980s. The implementation of new organizational structures that are more efficient, often because they are flatter and have improved communication and teamwork, will also enable firms to produce more with fewer workers.

The ultimate source of a nation's well-being is the skill of its workers and managers; that is, the quality of its human capital. We have already begun to see a substitution of quality workers for quantity of workers. In the 1990s, human capital will be enhanced through increased training and re-training of experienced adults. Much of the training will be provided by employers, in response to the need for employees who can produce better quality products with greater efficiency. The demand for training will accelerate as the half-life of worker knowledge becomes shorter. In fact, mid-career workers themselves will seek more training to gain an edge in the competition for scarce jobs and to facilitate their shifts from defense and other declining industries into growth industries.

The Composition of GNP Will Change

The 1990s should also bring some significant changes in the composition of national output and government finance. [Exhibit 3] The rate of spending by the federal government outpaced the growth rate of GNP in the 1980s. However, in the next few years, it is quite likely that government spending will fall relative to GNP, as defense spending falls, spending to deal with savings and loan problems tapers off, interest expense on the national debt declines, and unemployment is reduced. Nonetheless, constraining the longer-run path of government spending will still be a challenge because of pressure for new programs to address education, health care, and infrastructure problems, and the federal government's enormous exposure to risk in its many guarantee programs.

The federal budget deficit rose in the 1980s. Although the deficit's long-term trend is murky, it is likely to fall in the next few years, helped by the near-term slowdown in government spending growth and by the boost in revenue from an expanding economy.

Defense spending as a share of GNP rose from under 5 percent in 1980 to 6.6 percent in 1986. It has since fallen to 5.5 percent and, now that the Cold War is over, it is projected to continue to decline to under 4 percent in the 1990s. Increased defense spending during the 1980s contributed to the booms in places like Massachusetts and southern California. Now, in the 1990s, defense cutbacks will require substantial redirection of the productive resources in the regions that are heavily dependent on defense industries. Although these adjustments will be difficult and painful, the nation will clearly be better off, as it will be able to direct more of its resources to uses that will enhance our standard of living now and in the future.

Another change in the composition of the national economy is that personal consumption expenditure as a share of GNP, which was high and rising in the 1980s, will be lower in the 1990s. Consumption spending as a share of GNP rose rapidly in the early 1980s to a peak at the end of 1986, but has since edged down a bit, and the aging of the baby boom generation suggests a reduced emphasis on consumption in the 1990s. [Exhibit 4] Moreover, termination of the tax deductibility of consumer interest is discouraging borrowing to finance consumption.

The counterpart to a decline in consumer spending will be an increase in personal saving. [Exhibit 5] Moreover, since government deficits can be considered negative saving, or a use of private saving, the amount of saving available for use in business investment will also increase to the extent that the government deficit shrinks in the years ahead. With increased domestic saving, an increase in domestic investment as a share of GNP is likely. In addition, U.S. reliance on foreign savings, which is manifested in U.S. borrowing from abroad, should decline in the 1990s from the very high levels experienced in the 1980s.

An increase in outflow of investment funds to other countries is likely, although there will not necessarily be a net outflow. U.S. investment funds will be attracted by the new opportunities presented by four events: the demise of central planning in Eastern Europe and the former Soviet Union; the resolution of the debt crisis in Latin America; the reduction of restraints on economic activity that had been so pervasive in Latin America; and the improved investment climates in Canada and Mexico likely to result from the North American Free Trade Agreement.

International Commerce Will Flourish

In addition to positive changes occurring in the former Communist bloc and in Latin America, there are other ways in which the international economic environment will become more favorable for the United States in the 1990s than in the 1980s. [Exhibit 6] For example, the trade balance will improve, because the competitiveness of U.S. manufacturing has increased. The U.S. merchandise trade deficit peaked at $153 billion in 1987 and has since fallen to $65 billion in 1991. [Exhibit 7]

International trade will become even more important in the 1990s. Trade barriers erected for Cold War purposes will be removed, and barriers to U.S. trade will also fall as a result of developments such as the North American Free Trade Agreement. Growing international economic integration will increase the opposition to trade restraints, as more and more people and firms see direct connections between free trade and their economic well-being. Consequently, the total volume of trade -- imports plus exports -- which grew faster than GNP in the 1980s, will continue to do so in the 1990s.

Oil prices, which were volatile in the 1980s, are likely to be more stable in the 1990s. [Exhibit 8] Although the future is difficult to predict, my assumptions are that stable oil prices are a quid pro quo from Gulf allies for U.S. participation in the Gulf War; OPEC may have become less cohesive; and stable oil prices are in the Saudis' interest.

Another improvement in the international environment is that foreign exchange rates, which were volatile in the 1980s, are likely to be more stable in the 1990s. [Exhibit 9] Enhanced stability of exchange rates should result from greater stability in price levels and interest rates, both here and abroad. This assumes that U.S. and foreign monetary authorities will follow through on their assertions that they are assigning a higher priority to price stability.

Financial Conditions Will Be More Stable

Financial conditions should be more stable in the 1990s. [Exhibit 10] U.S. interest rates experienced wide swings in the 1980s, but should be lower and more stable in the 1990s, if the Federal Reserve is steadfast about pursuing price stability. [Exhibit 11]

Balance sheets should be stronger in the 1990s. For example, while corporate debt-to-equity ratios rose in the 1980s, they will fall in the 1990s. Many corporations became more highly leveraged in the 1980s as they issued junk bonds to buy back their stock. Now we are seeing a substitution of equity for debt as the excesses of the 1980s are corrected in response to the Tax Reform Act of 1986 and lower rates of inflation. Bank capital ratios also deteriorated in the 1980s, but will continue to strengthen in the 1990s in response to lower inflation, better interest rate margins, and government-mandated standards.

Three Sectors Needing Urgent Attention

Up to this point, I have focused on the positive, underlying forces that will shape the rest of this decade. Now I would like to discuss briefly three sectors of the economy where change appears inevitable. These sectors are construction, education, and health care. Improvements in these sectors can enhance the quality of our future. While the need for change in these sectors is so great that change is very likely, the ways in which the changes will be brought about are not yet clear.

Construction Will Shift Toward Infrastructure

In the 1980s, so many office buildings and shopping centers were built that they might not be fully utilized until after the turn of the century, and in some areas of the country there are also excesses of residential construction. Although we now have plenty of buildings, there is a great need for more infrastructure. Consequently, in the 1990s, emphasis is likely to be on the construction of roads and bridges, mass transit systems, schools, prisons, water treatment plants, sewage disposal systems, and trash disposal systems.

While current government deficits will make it difficult to finance the country's infrastructure needs, taxpayers do seem willing to approve tax levies earmarked for specific purposes, such as transportation, prisons, water projects, etc. Some infrastructure will be built by private firms, under arrangements where the firms are paid by the users of the facilities, such as toll roads; or where the firms contract to provide services to governments, such as prisons.

Elementary and Secondary Education Will Be Reformed

One of the implications of ending the Cold War is that our attention is shifting away from a hostile, possibly military, conflict with our ideological rivals -- the "evil" Soviet Empire -- toward economic rivalry with our political allies, especially Europe and Japan. In an age where value added depends increasingly on knowledge and information rather than on access to natural resources, success in the arena of global economic competition depends crucially on the effectiveness of educational institutions. U.S. colleges and universities are the envy of the world. And, we know why our higher education system is so good. Not because we spend more per student credit hour; we don't. Instead, it is because there is competition among higher education institutions for students -- consumer sovereignty reigns -- and there are incentives for educators to perform. Unfortunately, many of our government-operated primary and secondary schools -- especially in the inner cities -- are so ineffective that parents think the U.S. Postal Service could improve them. The failure is simply supply and demand. The suppliers of primary and secondary education -- teachers and administrators -- do not always have the incentives to be their best, and the demanders -- students and their parents -- cannot exercise consumer sovereignty through school choice.

In the 1990s, illiterate and poorly educated workers will find job opportunities scarce because freer trade and competitive pressures will result in the shifting of unskilled and semi-skilled jobs abroad. At the same time that those workers face unemployment, business firms will be facing a shortage of workers with the skills necessary to meet increasing demands for efficiency and quality. Rising numbers of unemployable workers and shortages of qualified workers are likely to provoke strong demands for reform of the educational system. Experiments and proposals to introduce privatization and competition into primary and secondary education are proliferating. Among them are government vouchers that can be used to pay for tuition at the parents' school of choice, and schools operated by entrepreneurs under contract to local school boards.

Health Care Spending Will be Constrained

Health care is the third sector where change is so badly needed that it seems inevitable. The cost of health care is very high and rising rapidly. As a share of GNP, health care spending has increased from about 5 percent in 1960 to 7 percent in 1970, 9 percent in 1980, and 12 percent in 1990. Moreover, increases in the numbers of elderly and continued development of costly medical procedures (advances in medical technology) will tend to escalate health care spending. If its recent rate of expansion were to continue, health care spending would reach 20 percent of GNP in 2017, and would eventually consume all of GNP. Of course, things that cannot continue forever, do not continue forever, but the method by which health care's share of national output will be constrained is unclear. Indeed, of the three sectors that concern me, this is the one for which the path of change seems the most difficult to envision.

Conclusions

Many of the basic forces and trends that are already in place will tend to make the 1990s better than the 1980s. We are going to have a more experienced labor force, and a population that saves and invests more and consumes less. Output-per-hour-worked will grow more rapidly. Many of the financial excesses of the 1980s are in the process of being corrected, and the international economic environment is becoming more favorable.

However, the people and all levels of government must make important decisions about how to provide infrastructure, education, and health care. The shape of these decisions is not yet clear. Whatever form they take, I believe they will be less costly and more effective if market forces are used. Allowing market forces to operate freely has proven to be one of our country's great strengths, and I am convinced it will continue to bring us prosperity in the future.

Exhibit 1

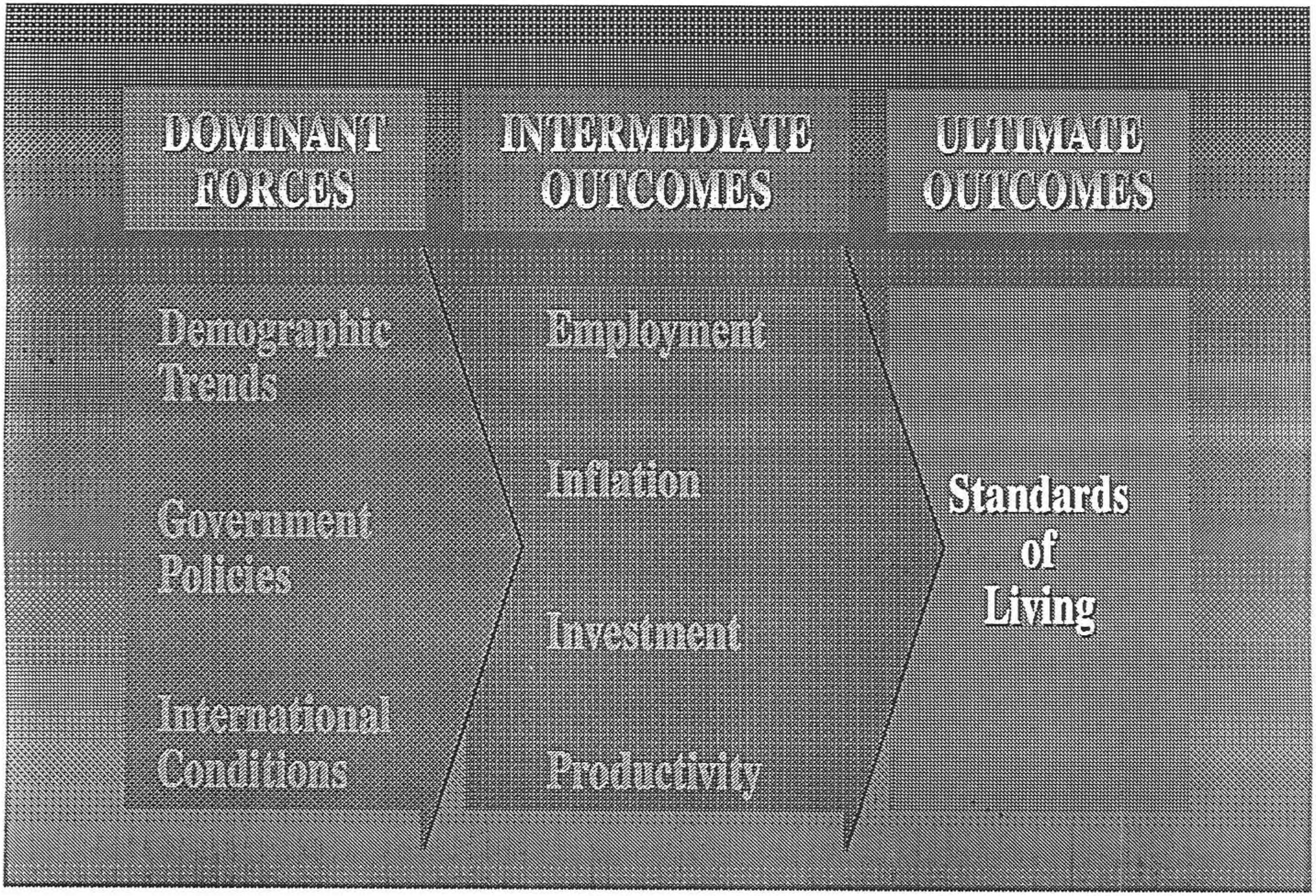

DOMINANT FORCES
INTERMEDIATE OUTCOMES
ULTIMATE OUTCOMES
Demographic Trends
Government Policies
International Conditions
Employment
Inflation
Investment
Productivity
Standards of Living

Exhibit 2

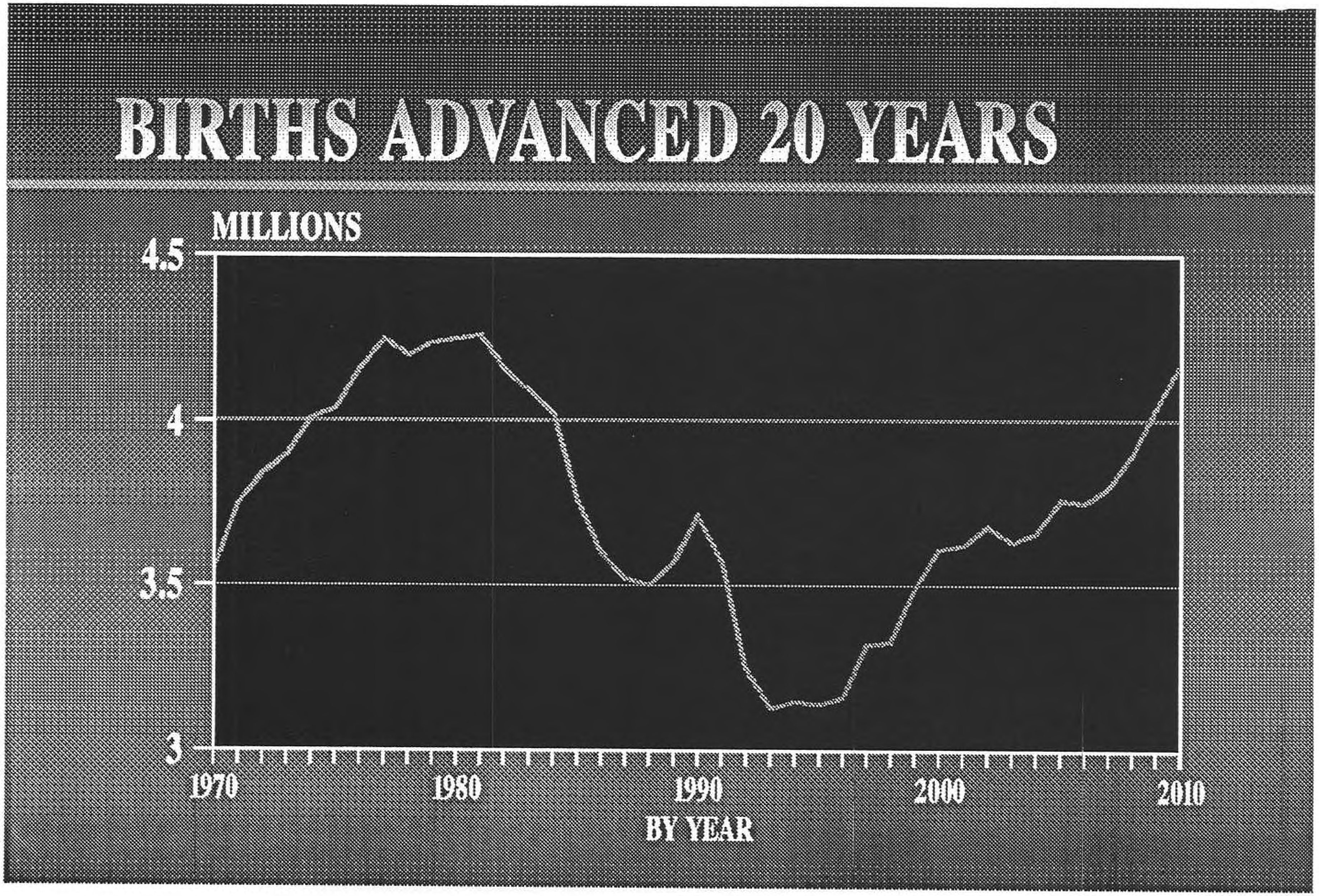

BIRTHS ADVANCED 20 YEARS
MILLIONS
4.5
4
3.5
3
1970
1980
1990
2000
2010
BY YEAR

Exhibit 3

ECONOMY

	80s	90s
Gov't/GNP	Rising	Falling
Deficit	Growing	Shrinking
Defense/GNP	Rising	Falling
Consumption/GNP	Rising	Falling

Exhibit 4

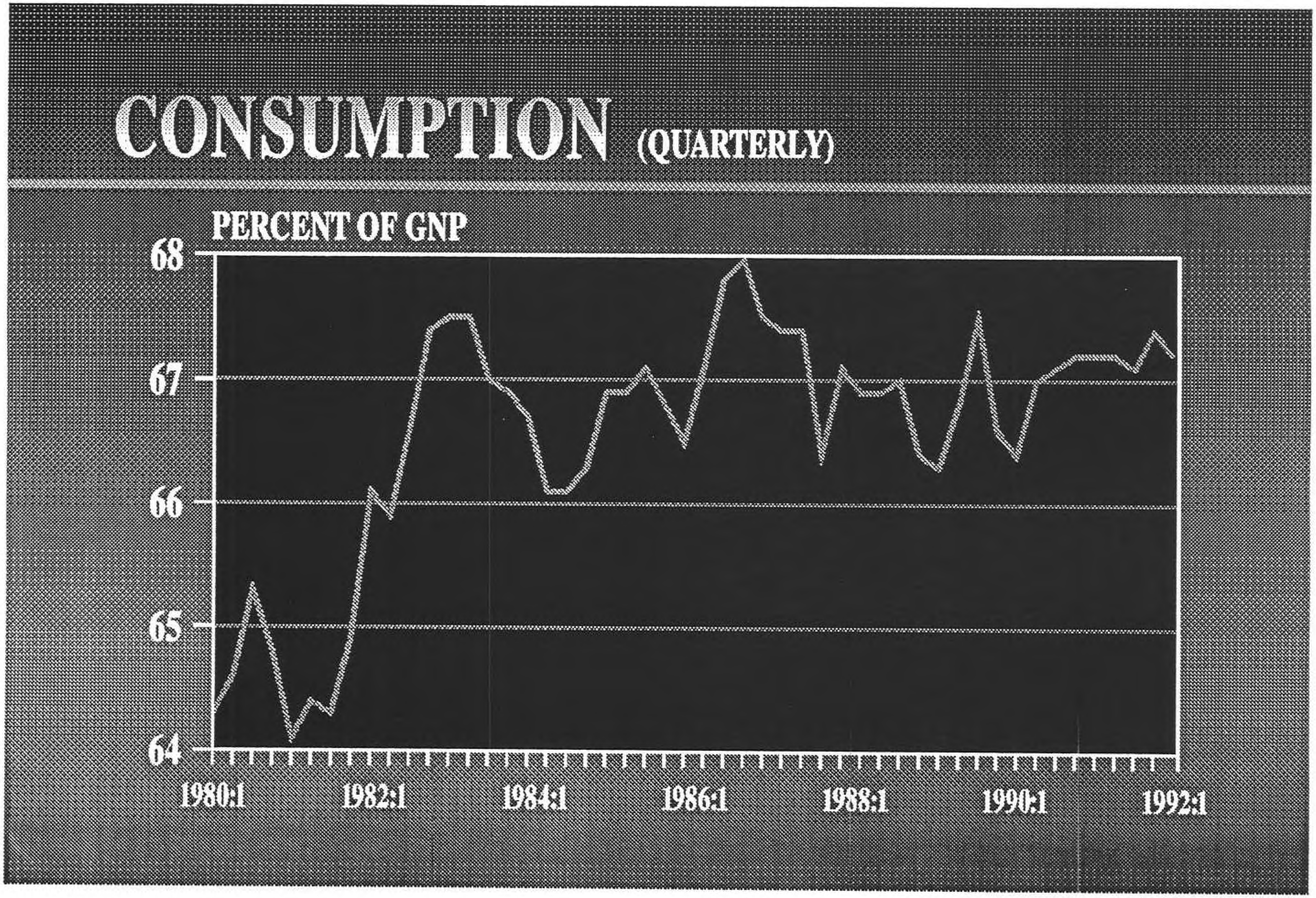

CONSUMPTION (QUARTERLY)
PERCENT OF GNP
68
67
66
65
64
1980:1
1982:1
1984:1
1986:1
1988:1
1990:1
1992:1

Exhibit 5

SAVINGS

	80s	90s
Savings Rate	Decreasing	Increasing
Government Dissavings	Increasing	Decreasing
Reliance on Foreign Savings	Increasing	Decreasing

Exhibit 6

INTERNATIONAL

	80s	90s
Trade Deficit	Growing	Shrinking
Trade/GNP	Rising	Rising More
Oil Prices	Volatile	Stable
FX Rates	Volatile	Stable

Exhibit 7

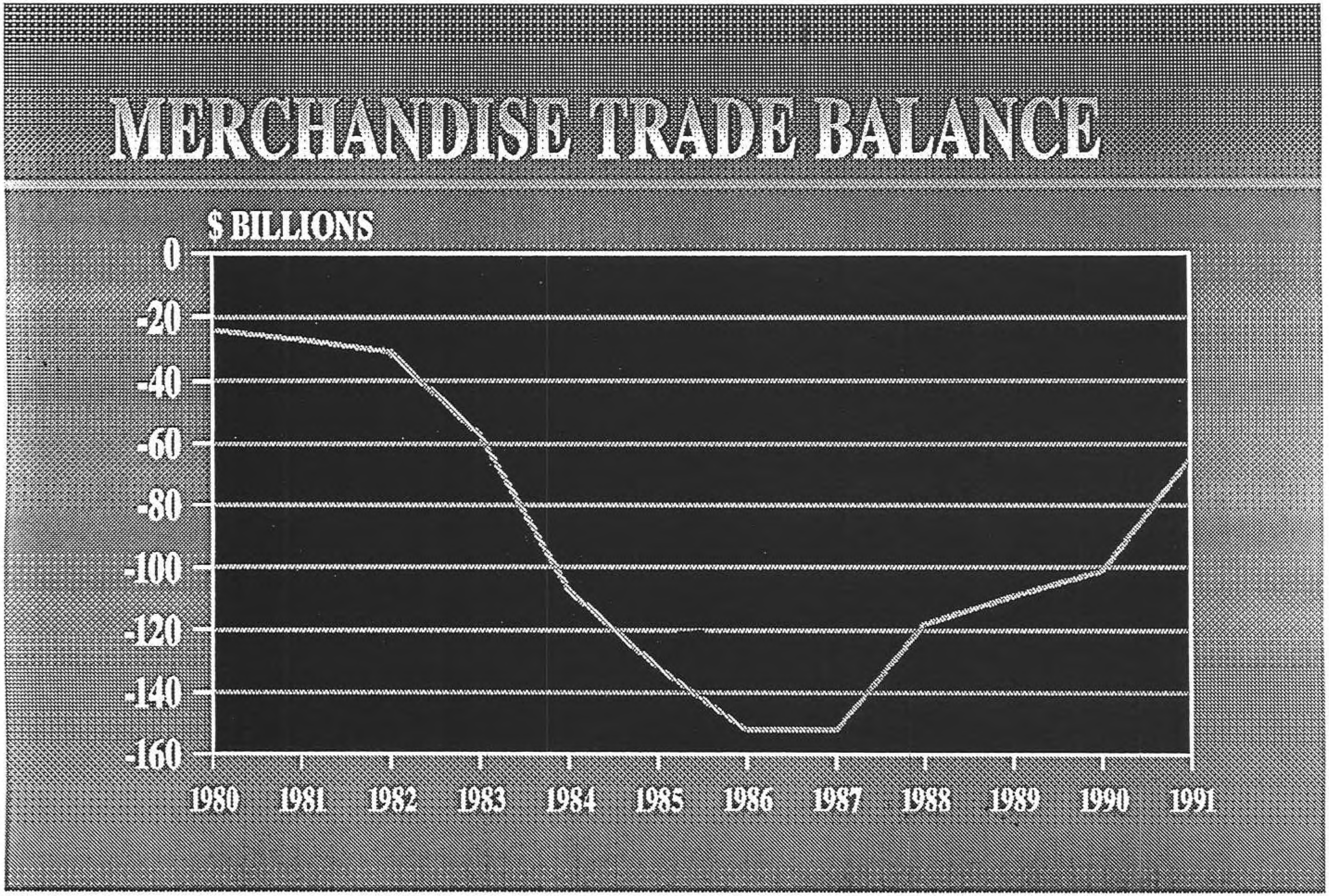

MERCHANDISE TRADE BALANCE
$ BILLIONS
0
-20
-40
-60
-80
-100
-120
-140
-160
1980
1981
1982
1983
1984
1985
1986
1987
1988
1989
1990
1991

Exhibit 8

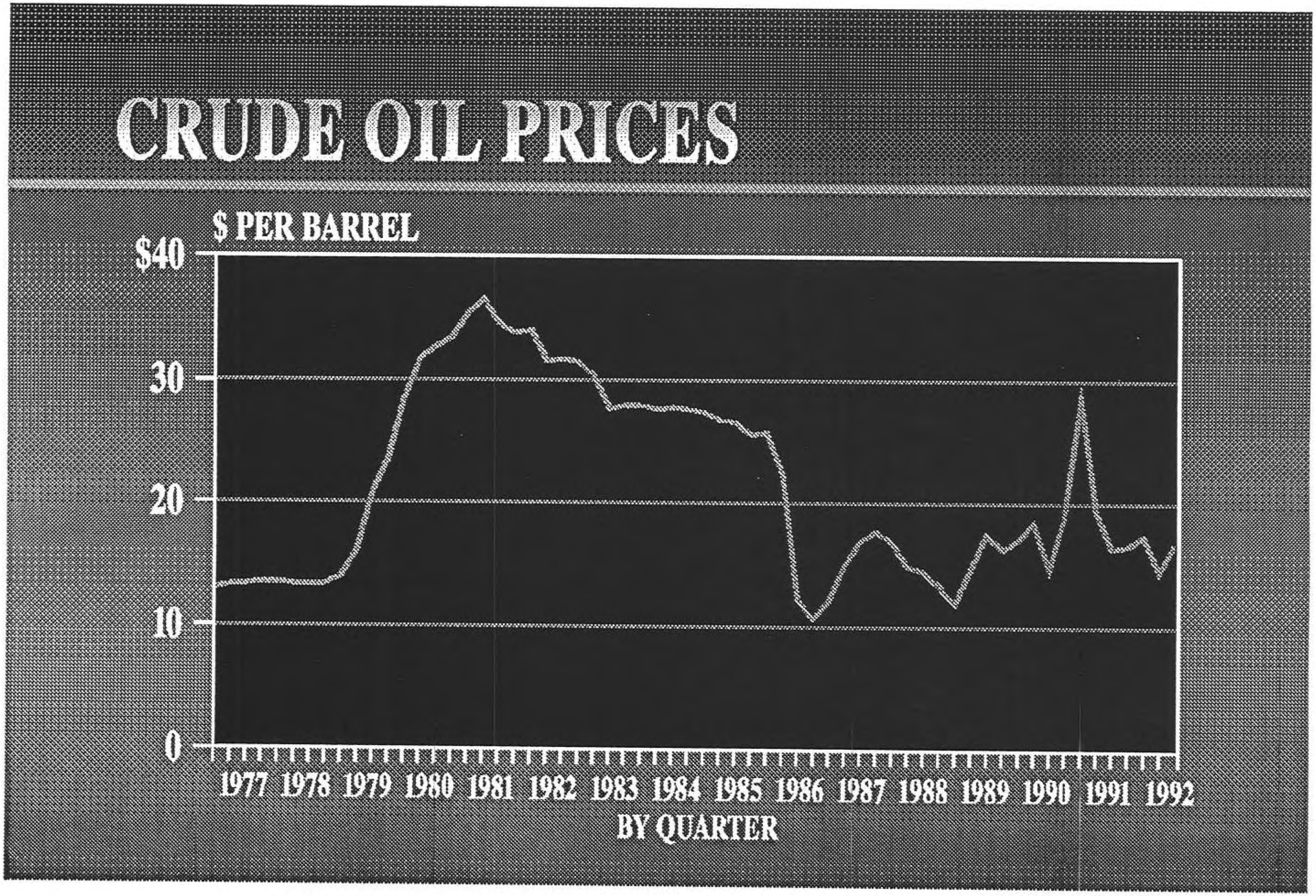
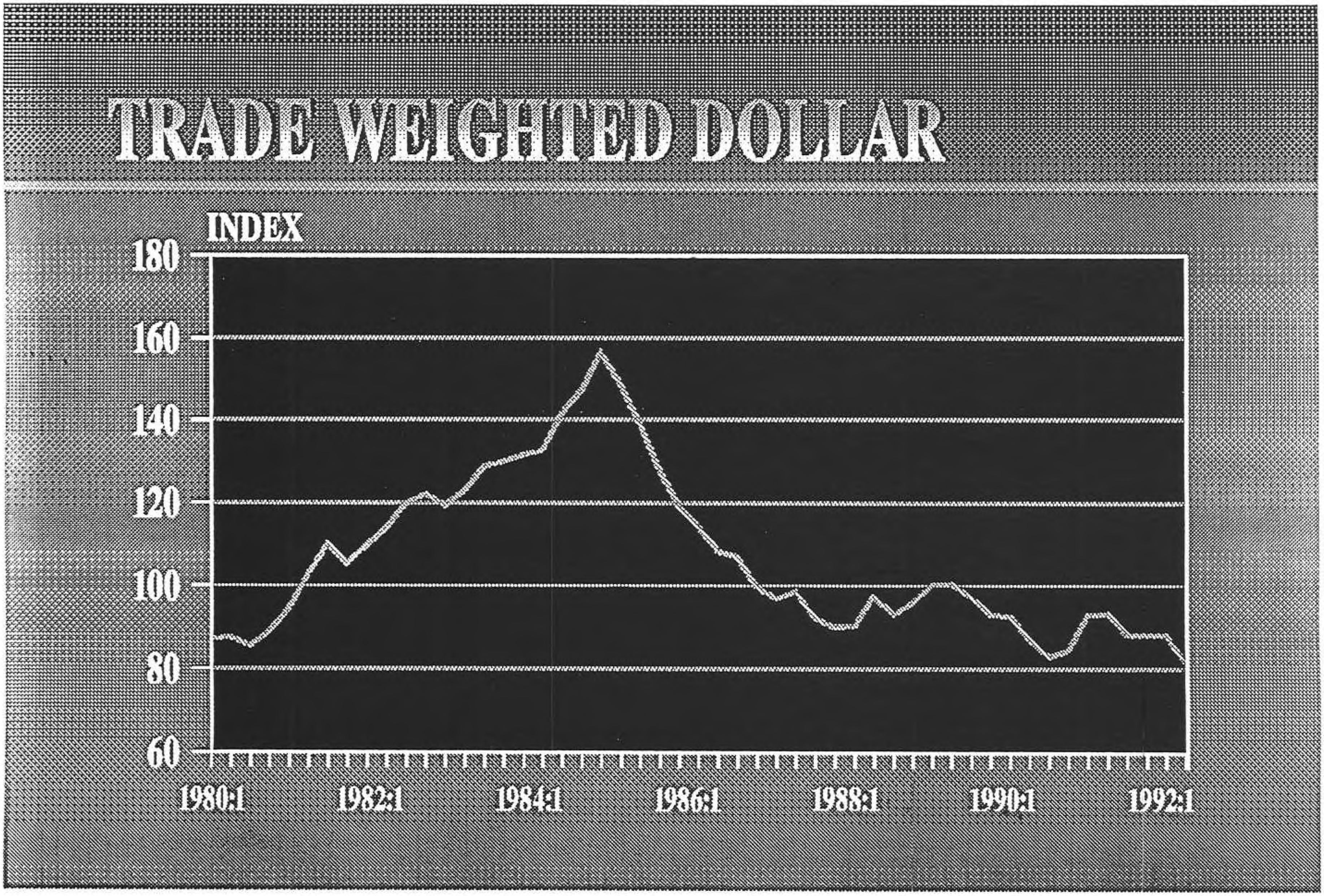

CRUDE OIL PRICES
$ PER BARREL
$40
30
20
10
0
1977 1978 1979 1980 1981 1982 1983 1984 1985 1986 1987 1988 1989 1990 1991 1992
BY QUARTER

Exhibit 9



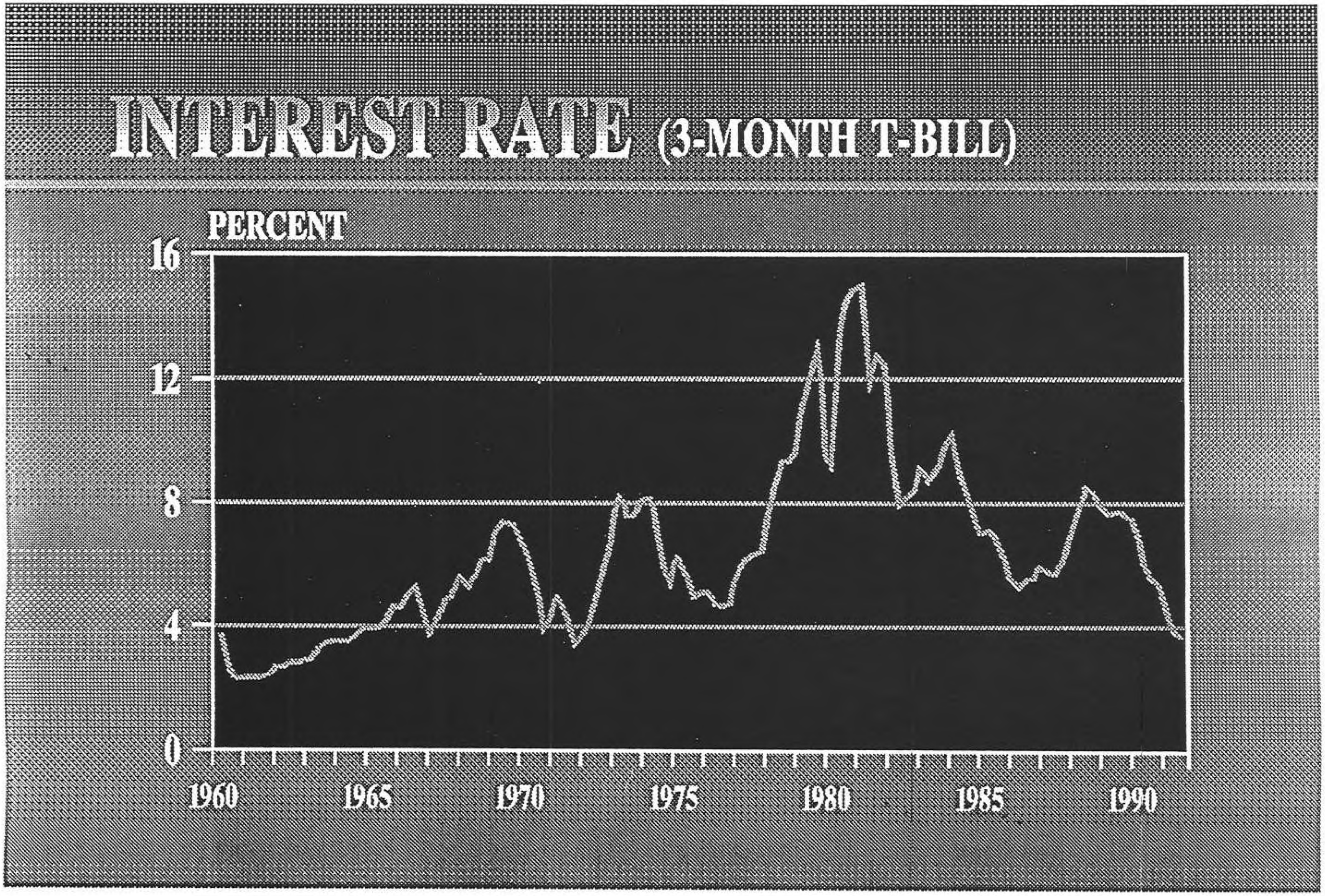
TRADE WEIGHTED DOLLAR
INDEX
180
160
140
120
100
80
60
1980:1
1982:1
1984:1
1986:1
1988:1
1990:1
1992:1

Exhibit 10

FINANCE

	80s	90s
Interest Rates	Volatile	Stable
Corporate Debt/Equity	Rising	Falling
Bank Capital Ratios	Weaker	Stronger

Exhibit 11



INTEREST RATE (3-MONTH T-BILL)
PERCENT
16
12
8
4
0
1960
1965
1970
1975
1980
1985
1990