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Changes in the Economic Environment: A Long-Run View

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Introduction

This morning I want to share with you some thoughts about why we have reason to be optimistic about the outlook for our world, our nation, and our community. That optimism stems from trends and forces in the political sphere, the economic sphere, and the technological sphere. Most of these trends are global in scope, and most have a strong element of inevitability.

The Long-Run Trends

The prospects for the next 10 to 15 years are extremely favorable and very exciting. Trends in technology and in political and economic institutions and policies will combine to produce what may turn out to be the best period since the 1920s and perhaps the best decade or two--ever.

Political Trends

Let's first look at some important political trends. Five months ago: 6th anniversary of when (November 9, 1989), the Berlin Wall came down, symbolizing the failure of communist central planning and the demise of the Soviet Empire.

Imagine just a few years from now, in the early years of the next century (and next millennium), teachers in high schools explaining to students that, in the middle of the 20th century, in the words of Winston Churchill, it seemed that an iron curtain had fallen through the middle of Europe.

Other side of curtain:

- no private property: apartments, shops, farms;
- could not buy products made in Western countries;
- no job changing jobs; could not "go into business";
- could not simply decide to move from one city to another; and you were not even allowed to travel outside the Soviet Union;
- or receive radio or TV news programs, newspapers, magazines, movies or any other information from the West.
- will sound obviously "dumb and unworkable".

The crumbling of the Berlin Wall will be treated in history as a major political event; but that does not explain the underlying forces at work that produced the political event.

In his book, Turmoil and Triumph, former Secretary of State George Shultz described his first meeting with Mikhail Gorbachev.

Shultz explained to Gorbachev that the accelerating pace of technological changes in information and communications was difficult for even the U. S. to keep up with, compared with places like Taiwan, Korea, Singapore and Hong Kong. Old Western Europe was falling behind the "Asian tigers", and for the socialist/communist, top-down, command-and-control economies, it was hopeless.

Gorbachev might have already recognized the power of such forces, and not long after taking power he launched his Glasnost and Perestroika reforms in an ultimately futile attempt to put some flexibility into the Soviet economy.

It is not so far fetched to say that our grandchildren will not worry about, and march in the streets to protest, nuclear missiles because of the technologies that brought us things such as FAX machines.

Certainly the young people that participated in the tragedy at Tiananmen Square understand the power of FAX machines and other information and communications technologies.

- then, after 40 years, of Soviet isolation, it seemed as though the political leaders one day said, "never mind", and the Iron Curtain suddenly collapse; -- symbolized by the physical destruction of the Berlin Wall.

The fall of the Soviet Empire means that nations throughout the world are either already democracies or they are moving toward democracy.

We are now half way through the final decade of a millennium, and it is difficult, at best, to absorb the fact that the spread of democratic political institutions and capitalist economic systems to more people around the globe is occurring at a faster pace in this last decade than during the first 990 years of the millennium.

- before Berlin Wall came down (just over 6 years ago) -- 20% in markets and democracy
- now, something over 50% of 5 billion people and rising rapidly.

Economic Trends

Let me turn now to some favorable *economic* trends.

For the past six or seven decades this century, we have witnessed a great "contest of ideas" between market economies and centrally-directed economies. The 1930s represented a watershed decade around the world. In the wake of a world-wide depression, the response in many countries was to greatly increase government intrusion into such decisions as what could be produced and where, how much things would cost, how much could be paid for labor, what interest rates could be paid or received, and even how much profit could be earned, interest rates paid/received.

- For over 40 years it was illegal for Americans to own gold
- For 50 years the government set a maximum interest rate people were allowed to earn on their savings.

The 1980s seem to have been another watershed decade, a time when previous beliefs about the appropriate role of government in the economy were questioned. People around the world came to recognize that living standards improved most rapidly in countries where markets, not governments, directed resource allocation. This is evident in comparisons not only between the centrally-planned countries and the western industrialized nations, but also among Third World countries with differing levels of freedom from government intrusion into everyday economic decisions.

Almost everywhere, government involvement in the economy is increasingly seen as a problem, not a solution. On every continent, we find examples of denationalization (privatization) and deregulation. It is hard to name a single country in which government is aggressively nationalizing private industry--instead, governments are either privatizing, deregulating, or maintaining the status quo. Controls on credit availability, interest rates, wages, prices, exchange rates, and capital flows are being removed. Such trends are likely to give a great boost to productive capacity during the next 15 years. In the jargon of economists, the world's production possibility boundary is being shifted outward.

Freer trade and capital flows. In addition to the movement toward greater freedom for markets domestically, there is a world-wide movement toward greater market freedom *between* nations.

These moves toward freer trade will make it easier for consumers to buy from the most efficient producers. In addition, the increased competition among producers will drive them toward greater efficiency and better service.

In some cases, free trade agreements include provisions for freer cross-border investment. This too will increase competition at the same time that it improves the allocation of the world's investment funds.

Another benefit of trade liberalization is that it increases pressure for domestic liberalization, that is, it increases pressures on government to remove restrictions that hamper the effectiveness of domestic firms. And, as domestic firms become more competitive, they in turn lobby for greater access to foreign markets. Thus, trade liberalization and domestic liberalization tend to be mutually reinforcing.

Several other important changes in economic institutions and policies will also be giving a major boost to economic prosperity during the next 10 to 15 years.

Counter-cyclical policies discredited. Over the last decade or so, the idea that fiscal and monetary policies can be used to fine-tune the economy has been largely discredited. The result will be that the amplitude of economic fluctuations will be smaller -- growth rates of output and employment in a narrower range, lower average interest rates, less variability of inflation. All this means a less uncertain environment for business decisions.

This new understanding about the limitations of government policies should contribute to greater prosperity by avoiding the harmful "pro-cyclical" outcomes that often result from those well-intentioned, but misguided, policies.

Price stability. Another beneficial trend is the substantial degree to which inflation has been eliminated.

- after 1973, on-the-job training at major central banks regarding techniques for stabilizing fiat currencies.
- most major nations, the inflation rate has been brought down to between zero and 3 percent.

Low inflation and, more importantly, the expectation that the purchasing power of money will remain essentially constant over time, is like a technological advance. It will release resources from inflation hedging and risk avoidance activities and allow those resources to be used to produce goods and services that raise standards of living. Lower inflation means a lower nominal interest rate which fosters a healthier environment for entrepreneurship. In other words, policies that lead to price stability are policies that promote growth.

Another trend is toward:

Balance budgets and smaller governments.

Today, we are all well aware of the popular consensus that the United States should move toward a balanced budget, the debate is only about when.

Deficits:

U.S.: 1983 = over 6%

1996 = about 2-1/2%

Bringing federal spending in line with revenues, with or without a tax cut, also suggests that government spending will become a smaller percentage of GDP.

This view has its counterpart in western Europe, where shrinking budget deficits is one of the agreed preconditions for achieving the European Community's goal of a European central bank and a common currency.

Reducing government deficits will increase national saving, making more funds available for investment and thus increasing production capacity. In addition, shrinking the relative size of government will mean that more resources are available for use by the private sector where they can be used more efficiently to raise standards of living.

Simpler tax codes. We also see serious proposals around the world for tax reform/tax reduction. The dominant trend is to tax consumption rather than income. Changing to consumption-based taxes will remove the disincentive to earn and produce, while increasing the incentive to save and invest. This will increase the funds available to rebuild our cities, increase our productive capacity, and raise future standards of living

- Early in the century (1913), tax rates on income: 1%-7%.
  - in real terms today, 1% up to $300,000
  - in real terms today, 7% only over $750,000

The objective of any new tax structure should be to reduce the resources that individuals and businesses use to devise ways of avoiding taxes. Tax reform would free those productive resources, such as accountants, tax planners, tax attorneys, etc., from activities that seek only to influence the *redistribution* of wealth, and instead allow them to be used to actually *create* wealth.

Technology -- Benefits and Challenges

- beginning of 20th Century -- wealth of nations
  - natural resources
  - raw materials
- national income accounting system --
  - numbers of things and tons of things
  - wheat, logs, coal and iron ore, etc.
- if natural resources actually were source of economic well-being.
  - Russia, Brazil, Africa
- instead, resources - poor places,
  - Switzerland, Japan, Taiwan, Hong Kong
  - size not important

- as century (and millennium) draws to a close,
  - knowledge-based, information-based
  - human capital
- good news and bad news
  - institutions of higher education -- colleges and universities, "envy of the world"
  - primary and secondary (especially in central cities) often fail miserably, especially compared to schools in global competitors such as Japan, Germany.
- no doubt, early part of the 21st century, overhaul way we deliver primary and secondary education
  - unsustainable: habit of ending
  - failure not an option; keep experimenting until we find a successful formula
  - as certain as the collapse of the Soviet Union, the tumbling of Berlin Wall, and the reunification of Germany. [Reagan: "tear down that wall"]
- rapidly advancing information/communication/data processing/analysis technologies all increase the premium on human capital.
  - failure to dramatically improve the quality of education for the half of our young people who do not go on to college would mean a sustained worsening of income distribution (economic well-being).

- clearly, in a democratic country, based on the principle of equal opportunity, growing disparity between the "haves and have-nots" would tear at the social fabric and undermine our political cohesion.

- while rapidly changing technologies are a challenge, they also offer solutions to the problems in our educational systems.

We are going to have to allow the marketplace to deliver education services in order to restore consumer sovereignty and provide incentives for effectiveness.

Problems: Measurement of Output/Productivity

Rapidly changing information and communications technologies provide a good illustration of an important point: much of the new economic activity that improves our lives is not counted in GDP. For example, much of the information and entertainment obtained from the Web is free. So, while it makes us better off, it does not show up as increase in real GDP per capita, which is a typical measure of the average standard of living.

In addition, much of what we *do* include in GDP undercounts its contribution to well-being. This is because of the increasing intellectual content of products and services, which makes it easier to have a disparity between the cost of production and the "true" value of the output.

- software diskettes
- durable goods, including PCs
- "Gone With the Wind; Star Wars/Empire Strikes Back/Return of the Jedi"

The shortcomings in using GDP as in indicator of real output and national well-being are not new. But, even though they are not new, they are becoming more significant, I believe, because the proportion of output and consumption that is conceptual rather than physical is increasing at an accelerating pace. So, a measurement problem that 50 years ago was perhaps trivial and certainly was not changing very fast, is now very significant and increasing rapidly.

A related problem is that our accounting conventions cause business spending on items such as computer software, research and development, and workforce training to be expensed rather than capitalized. Those items typically provide companies with a continued flow of productive services, in the same way that buildings and machines do, but because they are expensed rather than capitalized, they are not considered to be final goods and services and are not included in our measure of GDP.

- introduction of Windows '95 (capital stock) [tomatoes]

Although this shortcoming in our national income and product accounts is not new, it is growing in importance. For example, expenditures on computer software and worker training in its use, which were negligible as recently as a decade ago, are now quite large for most firms.

Thus, the trend toward greater intellectual content in both production processes and output is probably causing an increasing gap between measured GDP and the true value of our economy's output.

In summary, it seems to me that prospects for faster gains in prosperity are exceptionally good. Several important economic, political, and technological forces will work together to accelerate the growth of prosperity during the next 10 to 15 years. To some substantial degree, these forces are already boosting our well-being in ways that our conventional statistics are not capturing.

These are exciting times, especially for those of us who live in America. Let's meet our challenges with optimism. Thank you.