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Business Leaders: Thought and Action

"Cliffs Notes" for a Midterm Exam on The U.S. Economy

by Richard J. Mahoney

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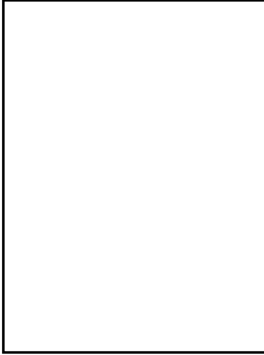


Richard J. Mahoney

This edition of The CEO Series is a departure from prior ones — intended to test readers on their knowledge of the U.S. Economy. “Cliffs Notes” — the test-takers' friend for many years — have been provided to guide participants to a greater understanding of the recent economic expansion and to the author’s “correct answer.”

EXAM QUESTION

The U.S. is in its seventh year of seemingly endless economic expansion. Optimism abounds. Two-thirds of American adults say the economy is “good or excellent” and 69% say it will only get better.

However, unless the laws of gravity and business cycles are repealed, there will sooner or later be a correction, followed by a downturn of uncertain duration. While times are good, we would do well to examine the causes for the remarkable economy so that they may be dusted off for use again when needed. The analysis is likely to be more objective now than in the typical climate of finger-pointing when things go wrong.

IN THE U.S. ECONOMIC EXPANSION, RATE THE FOLLOWING COMPONENTS:

1. FEDERAL RESERVE POLICY
2. EXECUTIVE AND LEGISLATIVE BRANCH INITIATIVES
3. BUSINESS ACTIONS

AS:	★	OF SOME VALUE
	★★	IMPORTANT
	★★★	CRITICALLY IMPORTANT

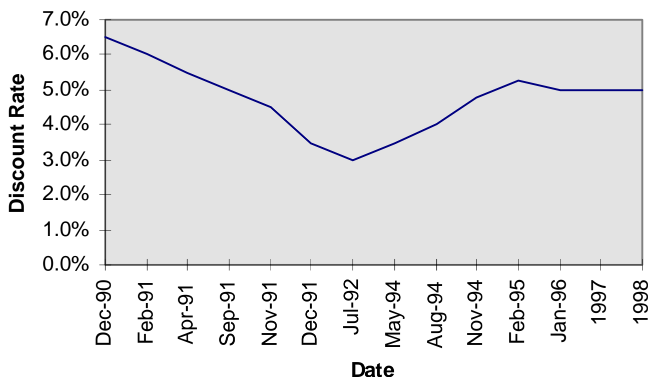
EXPLAIN YOUR RATINGS.

The following observations may be of value in your analysis.

Richard J. Mahoney is distinguished executive in residence at the Center for the Study of American Business and former chairman of Monsanto Company.

1. Federal Reserve Policy

- Since 1990, when the Fed Funds Discount Rate was at 7%, the Fed has taken the following actions on Discount Rates — a surrogate for interest rate change.



- The Fed has set an example for the world to notice. It has demonstrated its intent to stabilize inflation through its own actions and "jawboning" government spenders toward sound fiscal policy. "Speak softly and carry a big stick" was a useful slogan decades ago in foreign policy — it has been effective economic policy for the Fed in the 1990s.

2. Executive and Legislative Branch

- Reappointment of Alan Greenspan as Chairman of the Federal Reserve by President Clinton in June 1996 was a strong plus. Greenspan was designated Chairman by Presidents Ronald Reagan, George Bush, and now Bill Clinton.
- President Clinton's appointment of Robert Rubin as Treasury Secretary put into position a strong advocate for relatively conservative fiscal policy. Rubin has played an important role in steering the administration toward budget-balancing, thereby providing a climate to support debt market stability — and, indirectly, interest rate moderation.
- President Clinton signed into law the "Uruguay Round" of the General Agreement on Tariffs and Trade (GATT) in 1994. This reduction of tariffs and other trade-friendly agreements — the largest since the GATT was initiated some fifty years ago — has given U.S. exporters market opportunities while keeping domestic costs and inflation down through imports. The combination has played a significant role in the positive business climate for American companies. "The Uruguay Round" was

initiated during Reagan's presidency in 1986 and furthered actively by president Bush and ultimately, President Clinton. Clinton also obtained passage of the North American Free Trade Agreement (NAFTA) which, like GATT, started with Presidents Reagan and Bush. Its signing was a significant effort by the president in the face of opposition by his party. NAFTA is still in its early stages and will doubtless contribute significantly to the U.S. economy over time.

- The end of the Cold War in the 1980s allowed 1990s reduction of defense expenditures as well as market-openings with former adversaries. *The New York Times* columnist Louis Uchitelle characterized this among the "lucky breaks" that have helped the economy. Supporters of President Reagan's military build-up and his threats of the so-called "Star Wars" initiative argue that rather than "luck" these were conscious and significant contributing factors in the Soviet "implosion."

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- In one of the earliest proposals of his new administration in 1993, President Clinton offered an "economic jump start" plan. This ill-conceived federal grant of local "pork" as a "thank you" for election support raised questions about the new president's interest in fiscal restraint. Congress defeated the proposal, establishing *its* early fiscal credentials — and in doing so, sent a strong, positive message to financial markets.

- Congressional defeat of the Clinton health care initiative is viewed by most as strongly positive in that it stopped what might have been an expensive takeover by government of some 15% of the U.S. economy. In any case, the threat of government intrusion *did* unleash market forces of "managed care" which brought health-care cost inflation down dramatically from a 9% increase (1990 vs. 1989) to a 3.5% increase (1996 vs. 1995). Unfortunately, inflation once again appears to be picking up in 1998 due to price increases caused by the need to improve managed care profitability.

- Passage of the Clinton Budget Bill in 1993 elicits mixed reviews. Proponents of the plan argue that it set the stage for the eventual budget-balancing deal with the Congress and moved the economy strongly ahead, with stock market gains coming shortly thereafter. Opponents argue that it was the largest

peacetime tax increase ever and that little restraint in spending was visible outside of military cuts and the phaseout of the savings and loan bailout of the late 1980s and early 1990s. They further point to the fact that the economic expansion was already underway in March 1991, followed by a 2.7% increase in GDP in 1992, before Clinton took office. The specific effects of the massive tax increase of 1993 as a plus (cutting deficits) or a minus (taking productive capital for investment out of the economy) are not easy to analyze because they occurred simultaneously with a host of other factors. On balance, the *real positive* was that the Administration and the Congress signaled "intent" of fiscal restraint — a message heard loud and clear in financial markets. It may have been short-lived, however. The preliminary new signals could be interpreted as "spend, spend, spend" (see below).

- Passage of the Balanced Budget Agreement of 1997 was claimed and *ac*claimed by both parties. Led by robust tax receipts from stock market gains, defense reductions, elimination of prior savings and loan bailout costs, and other windfalls — the Congress and the Administration took credit for "courageous" moves to balance the budget. "Chutzpah" for taking credit for unexpected windfalls might be a better word than "courageous" for taking action. Little was *really* cut. Indeed, evidence is mounting that any anticipated surplus may well be spent in advance by both parties. Recently, conventional local "pork" proposals were called "infrastructure investment" by both parties in a rare show of bi-partisanship — a sad return to earth from prior heady statesmanship. It is as if both parties are saying: "We've tried governing *with* and *without* money and — *with* is better! Even if we're only imagining the *with* — we'll spend it."

3. Business Initiatives

- Reacting finally, after several years, to loss of competitiveness — starting in the mid-to-late 1980s, American manufacturers initiated major programs to improve quality, raise productivity, and lower cost. Annual capital investment in manufacturing (structures and equipment) rose in a decade from $76 billion in 1986 to $140 billion in 1996. Machinery and equipment represented 83% of the total — including significant expenditures for computers, which finally began to demonstrate their long-elusive productivity gains. In the same period, industrial R&D also nearly doubled to an estimated $134 billion in 1996. Of that R&D amount, 83% was funded directly from corporate (non-government) resources. The R&D funded both new product de-

velopment and process/cost improvement. This expansion of capital and R&D took place in a period of relatively low growth in sales and profitability. In addition, pressures were intense at that time from corporate raiders (and share-owners in general) to focus on the short term.

- Also during that period, U.S. companies were particularly disadvantaged versus their new major competitor, the Japanese — since American companies typically had to make their investments achieve a 12-14% cost of capital, while Japanese companies had capital costs in the low single digits. Facing these pressures, U.S. companies not only invested (and were criticized by their shareowners) but initiated layoffs, outsourcing and restructurings (and were criticized by the government and the public). In retrospect, these moves might be characterized as "tough love" — however painful to those involved — they did get results. Industry also initiated and benefited from alliances, collaborations, mergers, and a "return to basics," i.e., concentration on businesses that truly added value — discarding the rest and redeploying the capital.

- Perhaps not since World War II has U.S. industry made such a massive, positive turnaround in such a short period — and under so much counter pressure to do just the opposite. It was a collaboration by workers with "collars of all colors" that made it happen.

Perhaps not since World War II has U.S. Industry made such a massive, positive turnaround in such a short period — and under so much counter pressure to do just the opposite.

- U.S. manufacturers took full advantage of the GATT-induced export opportunities. Using their newfound competitiveness they increased merchandise exports from $213 billion in 1985 to $678 billion in 1997. Each $100,000 in exports is estimated to produce one new American job at an estimated 15% premium in wages over non-export jobs.

- Following the lead of the manufacturing industry, some four or five years later the service sector eventually moved on issues of cost, quality, and productivity with positive results in jobs, profits, and competitiveness.

- Inflation was kept in check by several factors. Fed-induced rates were under control. Worldwide competition in export markets kept downward pressure on prices and wages as did imports into the United States which tripled between 1985 and

1997. Attenuation of health care costs and falling oil prices also helped. Probably as important as any other cause was the "Wal-Marts of the world" saying to U.S. companies, "Our customers will no longer subsidize your inefficiencies — they want competitive prices (meaning the lowest), competitive quality (meaning the highest), and the very best terms of purchase." Industry listened — and acted!

ANSWER TO QUIZ:

1. Federal Reserve Policy ★★ (Important)

Fed policy was not just important for its action, which was relatively modest and infrequent — its *threat* of action was at least as important. It was a steady pressure for moderate inflation and thus relatively low interest rates — important for *real* growth and confidence to invest.

2. Government Policy ★ (Of Some Value)

The past three administrations have participated strongly in worldwide trade opening initiatives, which, combined with relatively low inflation, provided an excellent climate for business to succeed. In a sense, having seen the economy recovering, and with good underpinnings — the government largely got out of the way and *let* it happen. This kind of "benign neglect" is not a pejorative or "damning with faint praise" since it is all too easy for governments to meddle in the private sector. The current administration did not — except for its foray into health care and, along with Congress, into some lesser attempts to intervene in narrow economic issues which brought some good headlines, but were largely harmless.

Government would have earned a higher rating were it not for its spending proclivities both in the executive branch and the Congress which threaten to spend first and count money second. For example, when faced with the possibility of a budget surplus for the first time in more than two decades, government's actual and anticipated spending actions could well help cause Fed tightening and interest rate rises which could choke off the current growth. Fumbling on the five-yard line is not unheard of in football — and in government economic policy history!

3. Business Initiatives ★★★ (Critically Important)

The role of business in this phenomenal economic recovery is usually understated (or not stated at all) when credit is being passed out. Having personally watched the massive and expensive self-help efforts of the mid-to-late 1980s and early 1990s by company after company, I can attest to the courage of many in making the

important moves in the face of pressures *not* to act. The high rating is not for *intent* to act (government gets high marks for that) — rather, it is for *action and results.*

FOR FURTHER CONSIDERATION BY MIDTERM EXAM PARTICIPANTS

Using this analysis as a primer in understanding the current economy — for possible use in the next downturn—one can only urge that business and government act as if it is still the desperate mid-80s; we should keep the pressure on — instead of slipping back to spending excesses, as it is easy for corporations to do when times are relatively good and as is virtually *automatic* in government.

Indeed, we are already seeing a complete turnabout from fiscal restraint in government to plans for spending in *advance* of receipts — a return to the practice of spending more than is taken in, as in each of the past twenty-seven years. Perhaps an appointment of a "vice president of history" would be in order, in both industry and government, to keep the pressure on — to pretend it is still the *bad old days* when corporate quality and productivity were inadequate and desperately in need of improvement — and when government for its part had at least a sense of limits in its insatiable appetite to spend and meddle in matters better left to Economics 101.

Not all trees grow to the sky. We will eventually face a downturn. With that in mind, this planning phrase is useful:

> If you forecast the future only from the trend lines of the past — you'll be right 90% of the time, except for the 10% of the time when the dislocations occur and all the money is made and lost.

We should stall the dislocations for as long as possible by doing more of the many good moves that got us here. We should do them now — and keep doing them.

Then we'll really pass the test!

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