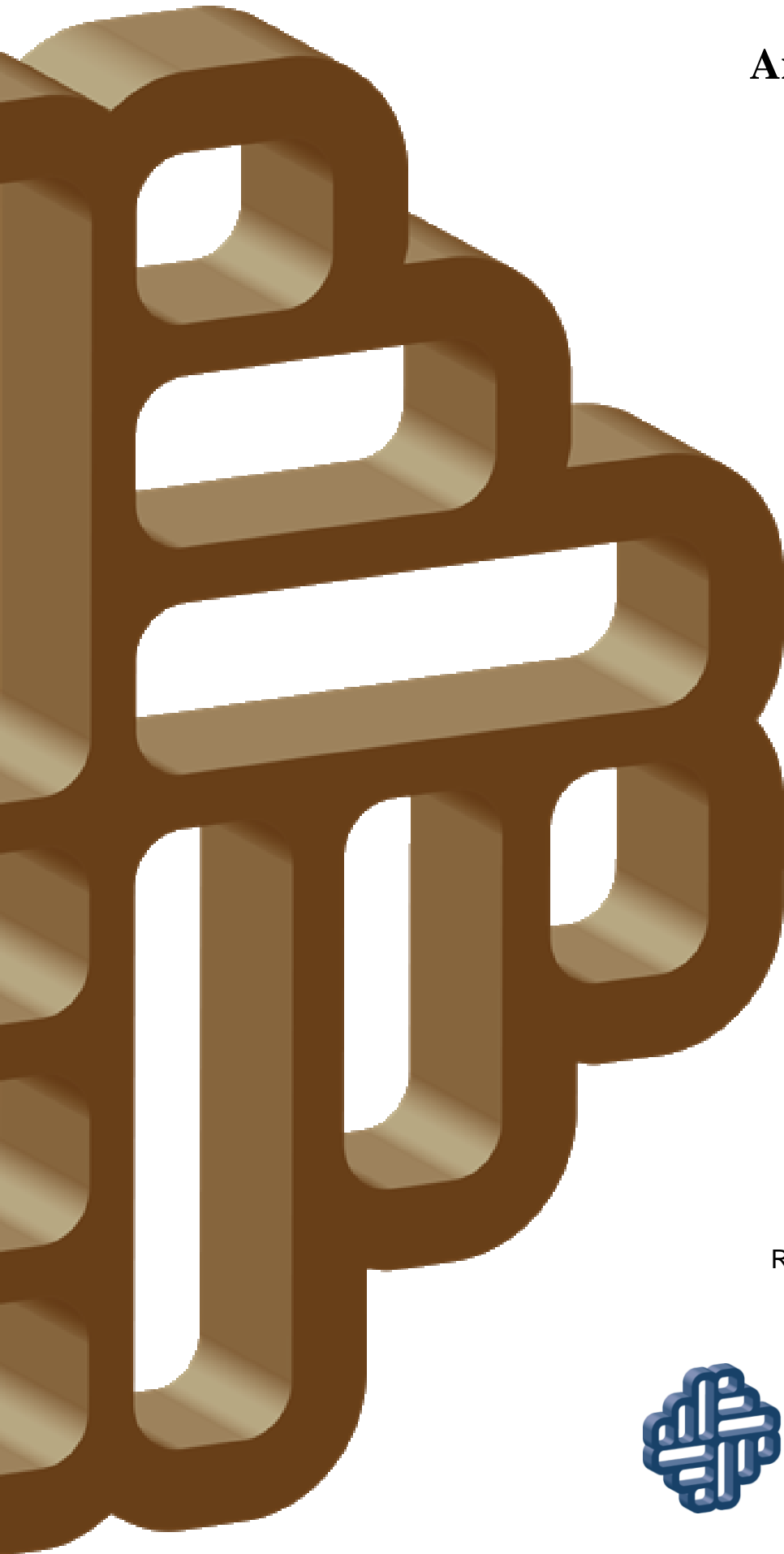


An Economic Report

The Coming Recession

By Ronald L. Garner
and Raymond M. Mullaney

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655 Main Street, Suite 211
East Greenwich, RI 02818
Ray@ExceptionalInvesting.com
CT (203) 254-0000
RI (401) 450-4040



**EXCEPTIONAL
INVESTING, LLC**

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The Coming Recession

Executive Summary

The Capital Companies has just completed an extensive six-month analysis of national and international economic trends. The conclusions derived from that work have prompted us to dramatically change our investment outlook and strategies. We are now forecasting an economic contraction in the United States during the next 24 months, preceded by a major downturn in the stock market. The four fundamental causes for our growing pessimism about the economy are:

- the nation's inability to export products competitively and the resulting balance-of-trade problems;
- the explosion of public and private debt, coupled with a lack of real economic growth;
- relatively small gains in worker productivity, which is causing real wage growth to stagnate; and
- a rekindling of inflation.

1. The nation's inability to export products competitively and the resulting balance-of-trade problem. This is a millstone around the economy's neck. America's trade deficit may hit \$150 billion dollars this year—an unprecedented sum. Productivity in the United States has been declining since the mid-1960s, while that of our European and Asian trading partners has dramatically increased. President Reagan's Commission on Industrial Competitiveness recently reported that the "United States had lost the race for international competition in manufacturing and risks losing it in high technology as well." Just as a family must live within its means, so too must a nation. In short, our country cannot prosper buying more than we sell.

Outlook: It is the opinion of The Capital Companies that most of the markets lost by U.S. manufacturers cannot be recovered. We acknowledge that lower interest rates and lower commodity prices—particularly oil—are benefiting American manufacturers. But those same factors are delivering even greater benefits to our international competitors. Moreover, we do not think the dollar's devaluation will produce big gains in manufacturing exports. Thus, Wall Street's expectation for a recovery in the manufacturing sector may not be in the cards. Finally, we expect foreign competition to increase in the months ahead, a situation that will only be aggravated if protectionist measures are enacted.

2. The explosion of public and private debt, and the lack of real economic growth. Over the entire history of the United States up to 1980, we amassed a national debt of \$1 trillion. In the past six years alone, we have added another trillion! During the 25 years prior to 1980 the total debt of American consumers had averaged about 140% of the nation's annual gross national product. Today that percentage is approaching 180%. In the business sector the rising tide of debt is even more alarming. We are deeply concerned that the economic recovery has been so largely funded by debt. Our nation seems to be trading off long-term growth for the pleasures of immediate consumption. We strongly suspect that if deficit spending were curtailed, or if the flow of foreign investment capital were to dry up, our economy would come to a grinding halt.

Outlook: We expect the level of government, consumer and corporate debt in the U.S. to continue to grow at unprecedented rates. The nation appears to lack the political will to face its mounting debt crisis, which can only be addressed through spending cuts and/or tax increases. At the same time we are skeptical that foreign participation in our credit markets will continue at the same high levels we've experienced over the past two years. As the dollar declines in value, yields on foreign securities will become more attractive and a major flow of foreign capital out of the U.S. market may occur in 1987. This will force our nation to internalize the financing of a larger percentage of our debt.

3. Relatively small gains in worker productivity. Rising productivity is the ultimate source of rising Living standards. Yet the U.S. is not making much progress in this area. Even in the current favorable environment of lower energy prices, lower inflation, and lower interest rates, recent worker productivity growth seems to be settling

down to less than 1% a year. The major precondition for increasing productivity is to add to capital formation and capital investment. This will require a national commitment to increase our rate of savings and to rebuild our aging industrial base.

Outlook: Since 1981, savings in the U.S. declined from 6.7% of earned wages to just 4.2%, placing the U.S. further behind its major trading partners in capital formation. Increased capital formation can only occur through more borrowing or by increasing our savings rate, which requires sacrifices in our current standard of living. It appears our society is unwilling to make certain sacrifices today that might ensure increased worker productivity and thus put our nation back on the road to financial solvency.

4. A rekindling of inflation. The decline in most commodity prices, particularly oil, has had a powerful deflationary effect on our economy over the past four years. Nevertheless the underlying inflation rate remains at a worrisome 4.5%.

Outlook: By the end of 1986, oil price declines will have worked their way through the system. At that time the decline in the value of the dollar will become a major force in rekindling inflation. As the value of the dollar decreases, the prices for imported products will rise. American producers, in turn, can be expected to raise prices to increase their margins even at the risk of losing additional market share. Additional inflationary pressure will be felt as the Federal Reserve prints more money to provide economic stimulus and ease credit costs, bail out failing banks, fund the Federal deficit, and support the financing requirements of Third World debtor nations. Finally, we expect oil prices to rebound next year, which will help fuel a new round of inflation. Our conclusion is that inflation in 1987 will accelerate into the 68 range or higher.

The Coming Recession

The Internationalization of the World Economy: Can the U.S. Remain Competitive?

The trade deficit is the most obvious and fastest-growing problem our economy faces, but it is also the one condition that, if reversed, might win the United States time to address its many other concerns.

Increasingly, we are made aware of the emergence of an international economy in which the U.S. is no longer the mainspring, but simply one gear among many. As much as we would like to resist such thinking, our nation has become uncompetitive in many major markets.

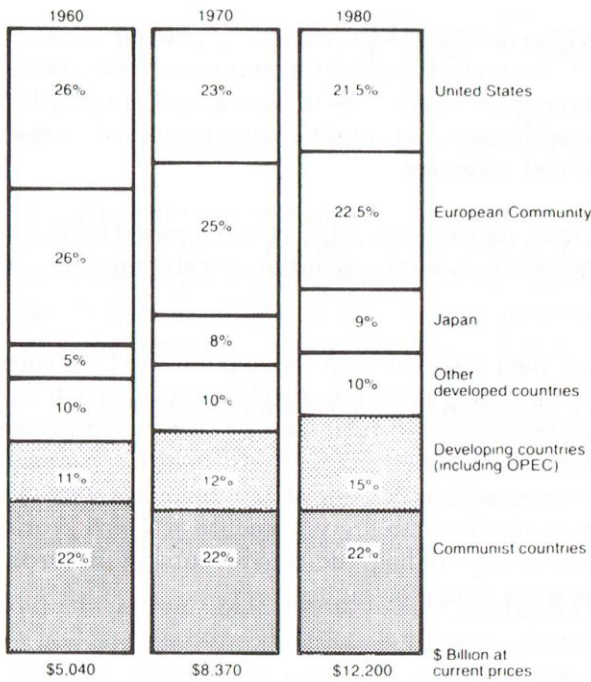
For example, 15 years ago U.S. banks dominated the working capital markets. Today the four largest banks in the world are Japanese. Similar losses in our competitive stance have occurred in automobiles, steel and electronics.

Although the United States continues to enjoy the world's largest economy, the economic performance of the United States has been declining in productivity since the mid-1960s. (See the adjoining chart.) Since that time we have become less competitive with our European and Asian trading partners who have been capturing markets once dominated by American manufacturers.

Enriched by their successes, our trading partners are now furnishing enormous amounts of capital to the United States. In this manner they have been financing our so-called "economic growth" and positioning themselves to own a growing portion of America's remaining industrial base.

If our nation continues to pursue the same political, economic, developmental, and international policies it has pursued over the past 20 years, it will continue to lose market share and American workers will continue to realize a decline in their real wages.

Shares of World GNP, 1960 – 1980



Source: U.S. Department of Commerce, International Trade Administration, *U.S. Competitiveness in the International Economy*, October, 1981

To regain our competitiveness, provide a rising standard of living, and begin paying for our huge domestic and international commitments, we must develop and pursue strategies that will enable us to compete for world markets. We must begin to retire the enormous public and private debt that has accumulated over the last 10 years. We cannot go on forever using credit to support a standard of living for which we are not paying as a profitable economic system.

Crisis in the Middle Class

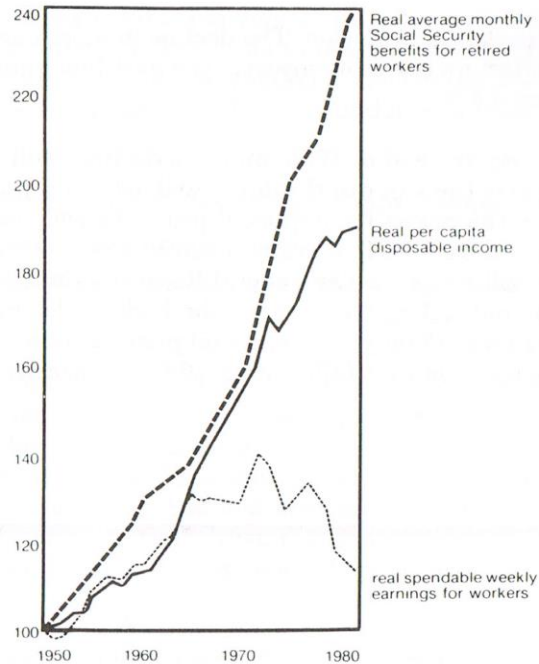
The middle class has always been a bellwether of America's economic health and vigor. Therefore, the mounting evidence of middle-class crisis is troubling.

The economic data of the past decade show that while the middle class in the United States is not disappearing, it is experiencing a dramatic decline in its ability to realize the American dream: a home, financial security, and education for children. To understand why this has happened and what the prospects are for the future, it's important to look at trends in income growth and economic growth.

For the last 11 years the American economy has been in a quiet depression in which neither wages nor family income have grown. Graphs on family income distribution look roughly the same today as they did in 1947. But statistics don't tell the full story.

For example, statistics conveniently overlook the fact that while the typical household in 1947 had just one wage earner, today's average household needs two to support it.

Indicators of Trends in Real Incomes United States, 1950 – 1982



Source: Harvard Business School researchers' calculations based on (1) *The Economic Report of the President*, Council of Economic Advisors, February, 1982, (2) *Supplement to Employment and Earnings, Revised Established Data*, Bureau of Labor Statistics, August, 1981, and (3) *Social Security Administration*, U.S. Department of Health and Human Services, May 1982.

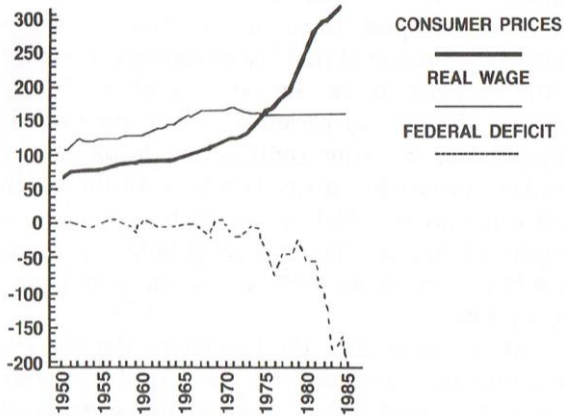
The Decline in Real Wages

When incomes are rising rapidly the middle class expands. In the United States this happened from 1947 through 1973 when real wages rose 2.5 to 3% per year. But in many ways 1973 was the last good year for Americans. After 1973, real growth largely stopped and family incomes began to stagnate. From 1974 through 1984 median family income has remained below its 1973 high of \$28,167. In 1984 it stood at \$26,433. Since 1984 we have experienced a slight increase in median family income, but it's still below its 1973 high point.

Productivity Slowdown

The large oil price increases that occurred in 1973 and again in 1980 each reduced our standard of living by about 5%. But even more important is the fact that worker productivity suddenly stopped growing after 1973, in that rising productivity is the ultimate source of rising living standards.

Declining Growth in Real Wages



CPI for Urban Consumers
Real Wage in Hundreds of Dollars
Deficit in Billion Dollars

Source: The Capital Companies

The growth in worker productivity has declined over the last 35 years to less than 1% per year. Many analysts believe that lower energy prices, lower rates of inflation and lower rates of interest will reverse this trend. But since energy prices, inflation and interest rates were not the causes of the decline in worker productivity, they can't provide the cures. Increases in worker productivity will require profound changes in our economic policies. In our opinion, the best way to boost worker productivity is to enact tax reform designed to discourage consumption, encourage savings, and expand capital spending.

It is particularly noteworthy that since 1981 the savings rate in the U.S. has declined from 6.7% to 4.2% of earned wages, placing the U.S. further behind its major trading partners in capital formation. Congress needs to address this point as a top economic issue. Other policy changes that merit serious consideration include further reduction of

individual tax rates, expanded investment tax credits, and the passage of large value-added taxes.

Growth of National Debt

The cost of maintaining our ambitious military and social goals in an environment of declining economic productivity, while enacting large demand-side individual tax cuts, has caused huge, unprecedented budget deficits. Our large borrowing requirements have caused high real interest rates and resulted in massive inflow of capital from abroad.

High Interest rates have also led to an overvalued dollar, which has eroded our world competitive position and led to the death of major sectors of American manufacturing. These problems stem directly from unrealistic political goals that delude us into thinking that we can somehow spend what we do not create. Like the lackadaisical grasshopper, we, both as individuals and as a nation, have ignored the consequences of our actions, basking in the sun of our delusion while the industrious ants work on.

From a pragmatic political and social point of view, the budget deficit, as well as the trade deficit, are understandable. By spending more than we take in and by importing more than we export, we can, for a time, live beyond our means. In this way we avoid the Limitations of stagnant incomes and avoid making difficult personal and political choices. If however, in the process we are creating a set of conditions that jeopardize our Long-range economic health. We are trading off long-term growth for the pleasures of immediate consumption. In other words, we are eating our seed corn.

There is no painless cure. Eliminating the \$200-billion federal deficit and the \$150-billion trade deficit will require tax increases, budget cuts, and ultimately a reduction in our living standards. It is bitter medicine to swallow and yet it is the choice we face. If we are unable to address these problems, it will remain for our children in the decades ahead to bear the cost of resolving not only their personal debt, but mammoth national and international debts as well. This would be a tragic legacy to leave.

The first step toward addressing our debt problem is to amend faulty economic theories that downplay the seriousness of the problem or suggest the deficits will somehow correct themselves. And clearly, we must deal with the partisan political paralysis that often denies Americans the opportunity for candid debate and positive action.

Differential Growth Rates

Country	Growth Rate of Real per Capita GNP (Percent)		Growth Rate of Real GNP per Employed Worker
	1870-1950	1950-1980	1970-1980
United States	1.9	2.0	.7
Canada	1.6	2.3	1.6
West Germany	1.0	4.9	3.1
France	1.1	4.4	3.5
Australia	n.a.	2.9	n.a.
Japan	n.a.	7.4	4.2
United Kingdom	1.1	3.2	2.0

Derived from *International Economic Conditions: Annual Data 1961-1980*, Federal Reserve Bank of St. Louis (released June 1981), and *Statistical Abstract of the United States - 1980 and 1981*.

Economic Signals

Stock Market: *The bubble will burst.*

Currently a large majority of market and economic analysts are optimistic in their long-term outlook for the stock market. These stock market bulls continue to believe that declining oil prices, stable interest rates, and steadily improving GNP growth will sustain a healthy stock market.

It is our opinion that these three legs to the bull market are shaky. We think the decline in energy prices is over and that inflation and interest rates have bottomed out. We believe that a major downward move in the market is more probable than a growing bull market.

Leading Economic Indicators: *Trouble lies just below the surface.*

Wall Street, the White House, and the press have reported “strong growth” over the last several months in the indices of leading economic indicators. The Commerce Department reported on May 30 that the index climbed 1.5% in April, its strongest showing in nearly three years. The index is a compilation of a dozen economic barometers that are used to forecast economic activity six to nine months into the future. However, the biggest factors pushing up the April index were the growth in the money supply, which was up .49%, and growth in outstanding credit or debt, which was up .24%. Other “positive” indicators were building permits, stock prices, and net business formation.

It is alarming, in our opinion, that only .2 of 1% of the April gain in the leading index was in the form of new orders (growth in manufacturing), which suggests the manufacturing sector is not poised for the big rebound that is generally forecast. Neither do we find much to cheer about in the trade deficit numbers, since we know the decline was mostly the result of lower oil prices rather than any fundamental improvement in the nation’s trade situation. In fact, during the month of April, while the level of imports fell, so did the level of exports. So far in 1986, exports are running below the average of the first four months of 1985. Agricultural exports continue to fall as they have in every month this year. We have not yet seen the benefits of the 30% decline in the dollar over the last year, and our position is that major improvements will not be forthcoming.

Many people in the investment and political communities believe that the economy will enjoy an

increase in manufacturing exports by year’s end. They theorize that the dollar’s devaluation will make American goods more competitive abroad. They also foresee generally improving economic conditions overseas, which would provide a lift for U.S. goods.

But we don’t support this scenario. We have yet to see any fundamental steps taken that would increase our international economic competitiveness. On the contrary, we see the trade imbalance worsening. The improvements in the trade figures that resulted from lower oil prices are mostly behind us now. As the manufacturing sector continues to slump, the nation’s trade deficit will swell.

Over the past three months the Commerce Department reported that the consumer price index (CPI) declined at an annual rate of 4.3%, the sharpest drop of any period since January 1949. It appears that a major contributing factor to the decline in consumer prices is related to the fall in petroleum prices, which, as we mentioned before, is largely behind us. The underlying inflation rate is still in the worrisome 4.5% annual range and moving upward.

At the same time the Commerce Department was reporting the decline in the April consumer price index, it noted that personal income increased at the rate of 1.2%. This increase seems to be quite healthy, and if taken at face value, would indicate growth in real wages. However, in looking below the surface, it seems that government subsidy payments to farmers increased sharply in April. Excluding government subsidy payments to farmers, income increased just two-tenths of 1% in April. *Thus, when viewed in the context of the underlying rate of inflation, and when energy prices are calculated out of the CPI, the American worker is still losing ground in his battle to maintain real wage growth.*

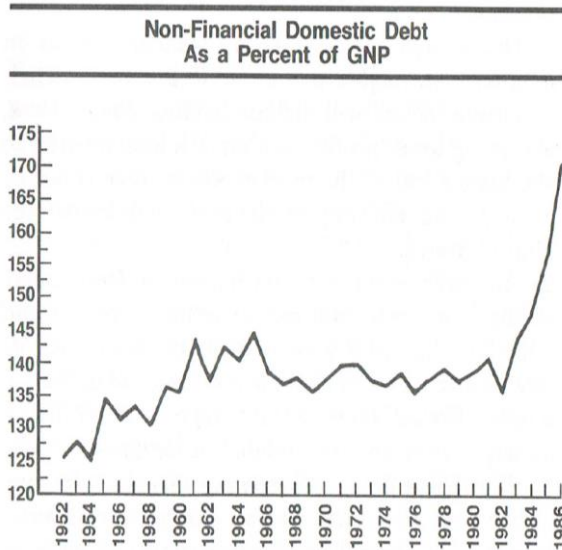
Another major concern is that new orders for big-ticket factory goods continue to fall. The April decline of .8% was the third consecutive monthly drop and the seventh in the past 10 months. This is a dismal statement on the condition of durable goods and capital goods sectors, and is consistent with the continuing weakness in the production side of the economy.

Public and Private Debt: *Financing growth with debt.*

The U.S. has been fueling world economic growth since 1981 through increasingly higher levels of consumer spending and large federal deficits. The extraordinarily rapid growth in public and private U.S. debt over the past three years is profoundly

disturbing and has serious implications for the economy.

Recent Federal Reserve figures show indebtedness growing at double-digit rates in each of the last three years, far faster than the increase in income. Total U.S. public and private debt reached a total \$8.2 trillion in 1985, up almost 100% since 1979! The growth reflects the huge federal budget deficit, growth in business borrowing to finance highly leveraged mergers and acquisitions, and increased consumer borrowing.



Source: Federal Reserve; U.S. Dept. of Commerce

Certainly there are many ways to look at this debt. One very important way is to measure the overall debt in the country relative to the gross national product. In the period between 1960 and the end of 1981, consumer debt averaged 138% of the annual gross national product, with very little variation on a year-to-year basis. Since 1982 we have seen a steady rise in the domestic debt every year; it now stands at approximately 175% of our gross national product and is still growing.

While consumer debt has accelerated, the total domestic debt, including that for financial institutions, has also risen. During the 15 years prior to 1982, total domestic debt averaged about 160% of GNP. Today it's running close to 200%.

The amount of debt on the nation's balance sheet is merely one part of a complex equation. Since we see no way of revoking the basic Laws of economics, which state that debt must be paid with earnings, we are left with three possibilities: 1) robust economic expansion sufficient to service the debt; 2) major defaults and liquidations; or 3) printing more money so that creditors can be repaid in cheaper dollars.

Experience has demonstrated that the most expedient political option is inflation. In fact, with Gramm-Rudman's constitutionality in question, we seriously doubt whether Congress has the political courage, particularly in an election year, to make any meaningful progress on deficit reduction.

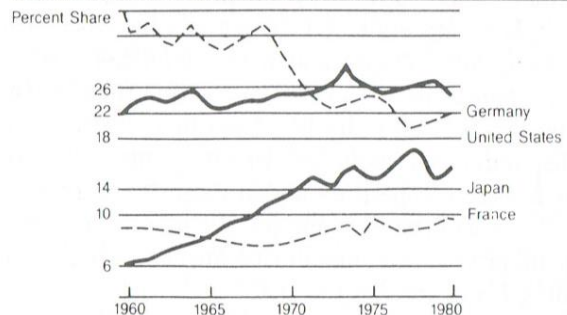
As the nation's debt continues to mount, it will have a more profound effect on the economic health of our society. Servicing an ever-increasing debt while real productivity remains flat or declines will bring inflation and an erosion in our standard of living. The concurrent loss of international markets will aggravate the problem further.

With real inflation-adjusted income trailing the growth in the Consumer Price Index, it is clear that the higher standard of living enjoyed by many American families has been made possible by incurring more debt. It is the same situation with our government. The country simply does not have the capacity to carry ever larger amounts of public and private debt without continuing to mortgage the country's assets and its future. This action is leading to a disastrous reflation of the economy. The U.S. consumer also has little capability to assume additional debt. In fact, our analysis leads us to conclude that the American consumer's financial position continues to erode.

Manufacturing: No recovery in sight.

Despite the ebullience on Wall Street, corporate profits have remained depressed or minimally improved at best. Bullish economists stake their position on the hope that the decline in the price of oil, along with the decline in the value of the dollar and lower, more stable interest rates, will prove to have a beneficial effect on profits and level of production in all sectors of U.S. manufacturing. Unfortunately, the causes of the decline in U.S. manufacturing are systemic and not merely a function of the current cost of money or oil.

United States Share in World Trade in Manufactures: 1960 - 1980



Source: United States Department of Commerce

Because of continuing world-wide competitive pressures, lower production costs (made possible by falling commodity prices, particularly oil) are not going to result in substantially higher profits for American manufacturers. The continuing price squeeze from foreign competitors means that any reduction in production costs are almost assuredly going to be in whole or in part passed along to consumers in order to maintain market share. If U.S. manufacturers attempt to increase profits by increasing prices—an alternative presently being attempted by U.S. auto-makers—the result will be further decline in market share and a resurgence of inflation.

In fact, the decline in the price of oil has generally been more advantageous to foreign manufacturers than to U.S. corporations. (Oil is priced in dollars; as the Japanese yen appreciates in value, it requires fewer yen to purchase a barrel of oil.)

Neither can U.S. manufacturers expect much relief from the devaluation of the dollar. Import prices are only rising marginally. The level of profits achieved by foreign competitors over the last few years allows a majority of our major foreign competitors to effectively compete under narrowing profit margins and changing market circumstances. In other words, they are under no great pressure now to raise prices.

In summary, we believe that the declining dollar will not force import prices appreciably higher. Increases in price that do occur will not be large enough to discourage most Americans from buying foreign products. Considered in another context, we note that foreign manufacturers now supply 26% of the U.S. market for all goods except farm and petroleum products. A decade ago it was only 13%, and only 20% at the start of the present economic cycle in late 1982. We believe foreign manufacturers' share of the market will continue to grow.

Ironically, the decline in the price of oil may turn out to be a net contributor to our balance-of-trade problem. While there are substantial savings being passed along to the U.S. by the reduction in oil prices, oil-producing countries, OPEC and non-OPEC alike, will subsequently have less to spend abroad. Since 1981, when oil prices were at their peak, U.S. exports to OPEC nations have declined by about 50%. The decline in oil will further weaken their opportunity to import goods from the U.S. Oil exporters will also buy less from manufacturers in other industrial countries, which in turn will give our foreign competition added incentive to protect their share of the U.S. market. With both the dollar and oil prices

lower, manufacturing costs abroad are falling faster than in the U.S.

Going further, our two largest trading partners—Canada and Mexico—can be expected to purchase fewer American-made goods for four fundamental reasons; 1) the devaluation of their currencies against the dollar; 2) the reduction in their revenues from oil and commodity sales; 3) the growth in their own levels of public and private debt; and 4) growing protectionist sentiments in the U.S.

The decline in commodity prices and high levels of debt in most Third World nations also diminishes the opportunity for U.S. manufacturers to build new markets.

Thus, we do not agree with the majority view, which holds that manufacturing in the U.S. will pick up over the next 12-18 months. In our opinion, American companies will find it increasingly difficult to expand production and recapture market share taken by foreign competitors for the following reasons:

1. *Our foreign competitors are tenacious, focus on long-term strategies, and are well capitalized.* Their defensive tactics will include holding down prices, accepting lower profits, selling at a loss, moving to the luxury end of the market where price is not so critical, and shifting production facilities to the United States.

2. *American manufacturers have completely abandoned many important consumer product areas and now lack the ability to re-enter markets such as television, compact disk players, and shoes.* For example, Kodak buys all its tape from TDK, a Japanese firm, and then relabels it for domestic sale.

3. *The U.S. market is becoming increasingly competitive as more Asian-based manufacturers enter the U.S. marketplace.* Because countries such as Japan, Korea, Singapore, Taiwan, and Hong Kong have such large populations, with few natural resources, exporting manufactured goods has emerged as the only means they have to participate in the world economy. While the Japanese have been enormously successful in penetrating traditional U.S. markets, they are now feeling competitive pressure from Korea and other Asian countries.

Moreover, the Korean, Hong Kong and Taiwanese currencies are pegged to the dollar, which means they have also depreciated against the yen. These up-and-coming Asian nations expect the Japanese to price themselves out of the market and are now entering the American market with lower-priced goods. (The Korean-built Hyundai automobile, priced at \$4995, is a good example.) The decline in the dollar means that importers of foreign products will be looking more to

these upstart Asian countries, instead of Japan, as a source of lower-priced product.

China is a sleeping giant of potential competition in the world market. During the first quarter of this year the Chinese announced plans to open four stock exchanges. They are also floating bonds on European markets for the first time since the 1940s. There is no question that China will represent formidable technical and industrial competition. For instance, China was recently awarded two contracts with U.S. corporations to place U.S.-built satellites into orbit.

In the final analysis, we don't foresee any reduction in foreign imports or expect foreign manufacturers to lose market share. Further, the payments from the U.S. for imported goods and services will continue at more or less their present level of deficit. The message in all this for American companies is a sobering one: *This marketplace is likely to grow more competitive with American manufacturers taking an increasingly smaller share of world markets.*

Interest Rates: No more breaks.

Foreign investors, whose purchases of U.S. government bonds is considered vital in financing the huge federal deficit, are slowly abandoning the market and taking some domestic investors with them. According to investment banking sources, overseas investors are increasingly shopping for bonds at home rather than in the United States, and some U.S. investors are following their lead, seeking currency and price gains overseas. This could bring about a rise in interest rates to help attract more buyers from overseas, and that, in turn, could stifle economic growth.

Interest rates will continue to be a real dilemma for American policy-makers. With U.S. government bonds currently yielding long-term rates of less than 8% compared to less than 6% for Japanese bonds, policy makers hope that foreign participation, from the Japanese, in purchasing U.S. debt will continue. But if the U.S. is forced to cut interest rates to avert a recession, it will risk a massive outflow of Japanese and other foreign capital. So the Federal Reserve must walk a thin line between recession and the loss of foreign capital. The simple solution—cutting the Federal deficit while simultaneously stimulating the Japanese, West German and other foreign economies—seems at this time politically unattainable.

Recently, the Japanese government made a modest effort to expand domestic demand. The Bank of Japan cut the official discount rate three times to its current level of 3.5%. Pressure is mounting for the Japanese

government to go further and dig into the government treasury to pump up the domestic economy. This approach would be in conflict with the government's longstanding policy of cutting government spending to control Japan's own national debt. Nevertheless, a program to spur domestic demand may be the only alternative if the dollar stays low relative to the yen.

As a result, we anticipate that there will be some inflationary pressures building in Japan. If that occurs, a rise in interest rates offered on their securities can be expected, creating further competition for capital in world markets.

Without maintaining the high interest rates that attracted so much foreign capital in 1984-1985, the economy may see an erosion of an essential element in financing its debt. If the dollar continues to fall as we expect, against the currencies of our major trading partners, especially Japan, the effect on the bond and stock markets will be dramatic and downward. Over the short term, the continuing decline in the value of the dollar will relieve a few of the major manufacturing dislocations suffered by the United States. However, the process is a long-term one, and the economy is going to suffer profound dislocations before we are able to develop and market new product lines.

International Trade: No cooperation.

Adjustments to global economic imbalances must eventually take place whether governments will them or resist them. Our major industrialized trading partners—Japan and West Germany—have confronted the cutting edge of the trade and currency realignment that began a year ago. They understand the realignment will continue unless a major coordinated intervention effort in the currency market is initiated. In fact, genuine economic coordination is even less likely today than it was a few months ago when the "Group of 5" met in New York. At that time the five largest central banks launched a successful assault on the dollar following a general agreement that it was overvalued. Today, following the economic summit in Tokyo, there is no such consensus about exchange rates or any other aspect of economic policy.

The U.S. has urged Japan and West Germany to take decisive steps to accelerate economic growth and to participate in world economic expansion. They have been reluctant to do so. At this writing, West Germany's industrial output is declining (-5% in March with unemployment at 9%) and the Central Bank has refused to lower interest rates.

American policy-makers would like the dollar to depreciate without fanning inflationary fires and they continue to pressure our trading partners to pursue expansionary economic policies. If this were accomplished on a coordinated basis, it could trim America's trade deficit and boost our economy. However, Japan and West Germany have refused our overtures for fear of losing hard-won market share in the U.S. economy. Without a coordinated policy and with a continuing decline in the value of the dollar, the U.S. government, acting alone, will find it impossible to correct the trade deficit and continue to control inflation.

We are convinced that U.S. policy-makers should rely less on the results associated with the value of the dollar. Rather than confronting the economic realities of our international trade problems, the U.S. has focused on tinkering with the dollar. Basic economic policies must be re-evaluated to address the real causes of currency distortions.

Inflation: *Waiting in the wings.*

American policy-makers will have to choose between two evils: inflation or recession. In a worst-case scenario, we could end up with both. As noted, inflation news of late has been generally positive, due in large part to the sharp decline in the price of oil and other commodities, and a slow-growth economy. Recent positive results may continue for several more months as the decline in the price of oil at the wellhead works its way through the production and distribution system. After that, we expect the inflation rate to increase.

With the Federal Reserve funding a huge federal deficit, bailing out U.S. banks and Third World debtor nations, while battling to forestall a recession, there may be no choice but to print great sums of money. Already there are signs of growing inflationary pressures. During the last quarter of 1985 and the first and second quarters of 1986, the M1 expanded at a hefty annual rate of over 10%. We anticipate seeing this aggregate move upward in months ahead. With a declining or static GNP and money aggregates moving upward, inflationary pressure will be renewed. Unfortunately, the Fed is going to have no room to raise interest rates in order to hold down these inflationary pressures.

In addition, the Federal Reserve will be fighting the battle alone. Because of unprecedented Federal deficits, during a period of economic recovery, the U.S. government has no capacity to forestall recession through traditional stimulative fiscal policies. We have, in the U.S., already expended that

option. The alternative course is an unthinkable \$300- to \$400-billion deficit.

Oil & Commodities: *Moderate upward price pressures.*

Presently the non-communist nations consume about 45.5 million barrels of oil per day, which is 2-3 million barrels less than production. That's not a huge surplus, but when considered in relation to global production capacity, which is as high as 60 million barrels of oil per day, the present production surplus is creating havoc with prices. If true free market forces were to prevail, prices of oil could fall as low as \$6-10 a barrel. At that price we'd expect marginal production to shut down and increased demand to soak up the remaining surplus.

Excess production capacity and supply now dominate almost all of the commodity markets. Whether or not free-market conditions will prevail over the long term is hard to say. Obviously, the ability of OPEC to enforce production and pricing policies could have a dramatic impact on the price of oil in the short term. However, discipline within the cartel doesn't seem achievable right now, so free-market forces will continue to hold sway. Over time, declining oil prices will eventually drive marginal production from the market and stimulate demand. But we don't expect significant upward pressures on the price of oil to be felt before mid-1987.

We anticipate that the price of oil will be approximately \$14-16 per barrel by October 1986, and \$22-24 per barrel within two years. The rationale for anticipating rising oil prices is that there is really only one country in the world that has an abundant amount of unused production capacity—Saudi Arabia. As the lowest-cost producer, the Saudis are currently working to manipulate the market. Once a country's production peaks, oil and gas production follows a declining curve. That is, as reserves become scarcer and harder to locate, every barrel of petroleum that is produced costs more. With tremendous amounts of unused capacity available, the Saudis don't have to deal with the decline-curve characteristics of oil production. Thus, they could very shortly regain control of world-wide production and pricing.

Production in the United States, which is a high-cost producer, will fall from approximately 8.9 million barrels a day at the present time to about 8 million barrels a day within one year. The Saudis will pick up that 900,000 barrels of production a day, and corrections in the demand-supply curves will begin to appear.

Analysis & Conclusions

1. *We don't expect the manufacturing and industrial sectors of the American economy to rebound.* It is our opinion that U.S. manufacturers have lost significant market share and are not likely to regain them in the foreseeable future. We believe that forecasts showing the economy growing at an annual rate in excess of 4% of inflation-adjusted gross national product are wrong and that the economic recovery is over. We acknowledge that U.S. industry is receiving the benefits of lower interest rates, costs, and commodity prices, particularly oil, but America's principal trade competitors have realized even greater savings. We think Americans will continue to show a strong preference for foreign-made goods and that the trade imbalance will continue at record high levels. Moreover, we forecast a sharp economic contraction in the U.S. over the next 24 months. The impending recession will be additionally severe if protectionist trade legislation is passed by Congress.

2. *We expect the level of public and private debt in the US to continue to grow at unprecedented rates.* This means the economy will be increasingly dependent on foreign capital. We are skeptical that foreign participation in the U.S. debt markets can continue at the levels we have enjoyed over the last two years. We think the continuing balance-of-payments problems will drive down the value of the dollar even further. As the dollar declines in value, yields on foreign-dominated securities are going to become more attractive and a major flow of foreign capital out of the U.S. could occur during 1987. This will force America to finance a larger percentage of its debt internally.

3. *Because of the fragile nature of the economy, we believe the Federal Reserve will have to walk a fine line between the need to stimulate the economy and the need to attract foreign investments.* These objectives are obviously non-complementary and cannot be mutually maintained. Probably, the Federal

Reserve, by taking the middle road, will not force rates low enough to rescue the economy nor high enough to assure a continual influx of foreign capital.

4. *We believe this year's oil price collapse, though substantially benefiting most Americans, has triggered an irreversible set of forces that will renew U.S. dependence on insecure foreign sources of petroleum.* Oil consumption is already beginning to go up and domestic production is dropping. For the longer term, growing U.S. oil imports will help foreign producers regain control of the world oil markets. We are becoming increasingly convinced that Americans again will face sharp price swings and even periods of tight supplies in the years ahead. It is not a question of if, but when, the next period of tightening supplies and higher prices will occur.

Currently imports are running about five million barrels a day, which is roughly 30% of our domestic consumption. By 1990 we estimate that total U.S. purchases of foreign petroleum will be approximately 10 million barrels per day—twice the current level—with imported petroleum accounting for 45-55% of total domestic demand. The 1973 oil crisis occurred when the United States was dependent on foreign sources for only 33% of its domestic petroleum needs.

5. *We foresee an acceleration in inflation in 1987.* Oil price declines will work their way through the price structure by the end of 1986. At that time the declining value of the dollar will be a major force in reigniting inflation. We foresee inflation in 1987 returning to the 6-8% range or higher. Because pressures for wage increases and higher commodity prices have diminished, world-wide excess capacity in many manufacturing industries and agriculture will reduce the ability of U.S. corporations and farmers to increase prices because of the threat of another flood of import competition and low of additional market share. However, the roughly 30% drop in the dollar against other major trading currencies since February 1985 carries a high inflationary potential. Monetary aggregates are going to accelerate rapidly.

The Capital Companies hopes that the content of this report is received in the same spirit it was written—a profound caring for our country and its future. We believe that the first step toward problem-solving is to recognize that there is in fact a problem. Beyond that, it will require sacrifices to right our economic ship. We have no doubt that once our nation's economic problems are made clear, Americans will respond with the same selfless energy that our forefathers displayed.

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Charts on pp. 4 and 7 reprinted with permission from George C. Lodge and Bruce R. Scott. U.S Competitiveness in the World Economy: A Problem of Premises. Boston, MA: Harvard Business School. 1984. Working Paper 9-785013.

Suggested Reading

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