Economic Gridlock In the Offing

Interview with Lester C. Thurow, professor of economics, Massachusetts Institute of Technology by Munemichi Inoue

Lester C. Thurow, MIT professor of economics, is a strong and highly respected critic of conventional economic thinking. While arguing that Reagan's abandonment of supply-side economics and monetarism has led to America's present Keynesian-style recovery, Thurow rejects traditional Keynesianism as the answer to America's economic problems.

The author of the best-selling *Zero Sum Society* and a contributing editor to *Newsweek*, Thurow voices his concern that the U.S. recovery may run into serious trouble in 1985 if nothing is done to correct the currency misalignment, the $100 billion U.S. trade deficit, and the $200 billion U.S. government deficit.

While the trade deficit problem goes hand-in-hand with those of high U.S. interest rates and the overvalued dollar, Thurow also points out that the deficit is the natural result of a global recovery led by only one locomotive—America. He warns that Reagan's laissez-faire attitudes are allowing the trade deficit to mount to where it will pull the dollar down sharply, triggering a panic on the exchange markets.

On the government deficit, Thurow contends that Reagan's pursuit of higher defense spending and refusal to raise taxes leaves no room for the major deficit shrinkage needed to ensure affordable business plant investment loans for a sustained recovery past 1984.

On labor-management relations—a subject ignored by most supply-demand theorists—Thurow goes beyond the level of union-management relations to discuss such human issues as the "turnover mentality" and the need for greater motivation and team work.

Finally, Thurow questions both the truth and the wisdom of the popular notion that the U.S. is becoming a primarily service-oriented economy and insists that expanding the services in place of the manufacturing industries can only weaken the economy.

Question: *First of all, I would like to ask you about Reaganomics.*

Thurow: Reaganomics started out as supply-side economics and monetarism, and now both of those ideas are more or less dead.

Monetarism died in August 1982, when the Federal Reserve Bank, given the choice between easing the money supply and watching Mexico and some of the bigger American banks go broke, quite wisely decided to abandon its monetary growth rate targets. In the last 12 to 15 months, the money supply has been growing at about a 12% or 13% rate.

Supply-side economics was supposed to mean tax cuts to stimulate savings. What those tax cuts actually did was stimulate consumption, and the savings rate in the United States has fallen to an all-time low. In addition, there have been very large defense-related increases in the federal budget that have swollen the federal budget by 32% in just four years.

Q: *It sounds very Keynesian.*

Thurow: The United States is having what I would call a standard Keynesian recovery. If you combine large budget increases with consumption-oriented tax cuts and easy money policies, what you get is classic Keynesian economics. Ironically, Ronald Reagan is proving that Keynesian economics works, at least in terms of causing a recovery. The current recovery is only a little weaker than previous post-World-War-II recoveries, and it should hold at least through 1984.

Q: *What about 1985?*

Thurow: This recovery began with an inventory rebound, and now there is a consumer boom. In 1985, we will need growth in business plant investment to sustain the recovery. However, the big government deficit and the low savings rate will make it difficult for business to afford plant investment loans. Normally, when businesses begin borrowing for plant investment, interest rates are pushed up until they discourage further borrowing and squeeze off the recovery. But if interest rates are allowed to go up, heavily-indebted nations such as Brazil, Mexico, and the Philippines will default. Each percentage point rise in U.S. interest rates costs Brazil about US$900 million—money they obviously don't have.

Prof. Lester C. Thurow

"A problem with the recovery is that there is just one locomotive"

A second problem with the recovery is that there is just one locomotive. In the past, there were expectations that there would be three locomotives—Japan, the United States, and West Germany. There aren't. West Germany is expected to have a positive rate of growth in 1984, but such slow growth that it won't be able to keep up with the labor population growth, and

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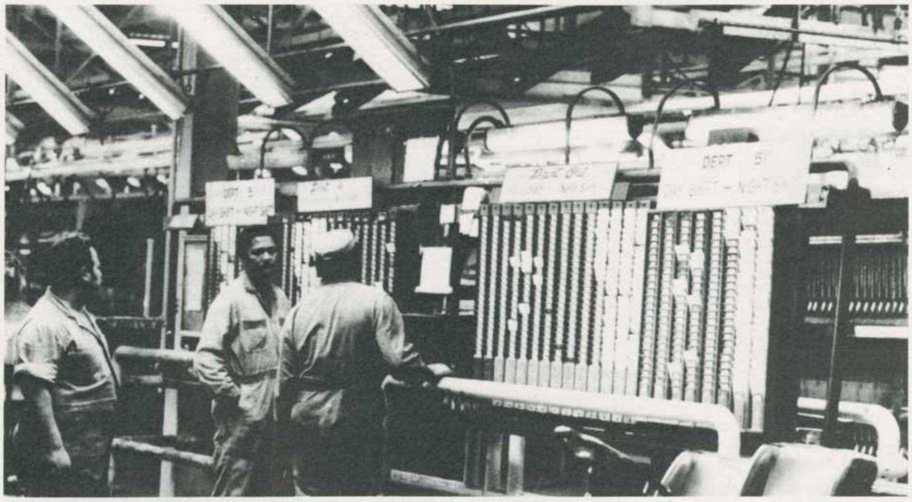

Photo: WWP

The average U.S. manufacturing company loses about 50% of its employees every year.

unemployment will be up from the 9% now to about 10.5% by the end of the year. The Japanese forecast is for continued growth of about 3 or 4%, but this growth is heavily dependent upon exports. Therefore, with neither Japan nor West Germany working as locomotives, and with just the United States pulling everyone along, America's $100 billion trade deficit is only natural.

Q: *How has this trade deficit affected the U.S. economy?*

Thurow: First of all, a $100 billion trade deficit means 2.5 million fewer jobs. Since about one-fourth of that deficit is with Japan, that means that about 700,000 of those jobs have been lost to Japan—a fact that U.S. protectionist interests have not overlooked.

Moreover, the dollar is bound to fall at some point, even if U.S. interest rates stay high. You can't have a $100 billion deficit year after year without its eventually having a serious effect on the value of the dollar. Whether the fall comes in six months or in 18, it will be marked by two characteristics: it will start out very rapidly and it will no doubt over-correct as exchange rates have done ever since they were set afloat. So on the assumption that the dollar is overvalued by 25%, when it falls it will go down by more than that. This sharp fall will mean that those 2.5 million jobs will be transferred back to the United States—much to the detriment of some other nations' recoveries. No one knows just when this fall will happen, but it is likely to happen in 1984.

So the twofold problem of the overvalued dollar and the trade deficit will cure itself sooner or later—it's just unfortunate that so little is being done to cure it sooner rather than later. If we simply let the market mechanism decide when the dollar will fall, people who are investing in the dollar for the extra 5% or so in interest it offers will face major foreign exchange losses if the dollar falls 10% or more before they can get out.

Q: *And what do you suppose they will do when the fall begins?*

Thurow: Dollar investors are already watching nervously for the first signs of a fall, and they are ready to rush out when it starts. They will most likely go into West German marks, considering that Japan still makes it somewhat difficult to rush into yen. But if everyone tries to buy marks, that will be very disruptive to West German exports and to the West German economy—as well as the Common Market and European currency alignment.

"The solution creates an irresistible object and an immovable force"

Q: *Assuming your predictions prove true and the U.S. economy does run into problems sometime in 1985, what should be done to solve these problems?*

Thurow: It's easy to say what should be done, yet it's rather difficult to do it. As for the threefold problem of the government deficit, the crowding out, and the low rate of savings, the obvious solution would be to shrink the government deficit in 1985. But that "solution" creates the combination of an irresistible object and an immovable force; the irresistible object being the arithmetic of the government deficit and the immovable force being President Reagan's conviction that taxes must not be raised.

The government deficit currently stands at about $200 billion. It is impossible to eliminate this simply by cutting the federal budget. If you take the $200 billion out of defense, that's about 70% of the defense budget. A $200 billion cut from Social Security would remove 80% of that budget. These two fields are also out because President Reagan says his top priority is to raise defense spending, voters are not going to countenance social security cuts, and Democratic congressmen refuse to consider cuts in social spending without concurrent cuts in defense. Debt service is also out because there is no legal way to cut the interest on the national debt. The remainder of the federal budget adds up to about $200 billion, but cutting that would leave no money for roads, parks, police, the weather bureau, and other vital areas.

Since you can't cut $200 billion out of the budget, the only other option is to raise taxes, something which the President is adamantly opposed to. Some people are saying that Reagan will probably raise taxes in 1985 if he is re-elected, but I have seen nothing to support that prediction. President Reagan's entire political career has been founded on the belief that we should cut taxes, and I doubt if he would make such an about-face in 1985.

So, given the arithmetic of the government deficit and the basic beliefs of President Reagan, I don't see how we can solve the government deficit problem in 1985.

"You can only raise workers' wages by raising their productivity"

Q: *Productivity has also been cited as a factor in the U.S. trade deficit. Do you see any solution here?*

Thurow: Not yet. Productivity growth has begun to rebound, but much of this is tied to the cyclical recovery in the economy. The United States is reaching the point now where the growth in the labor force is beginning to slow down, so not as much capital labor investment will be needed for keeping up with the growing labor force. Nonetheless, even with a slight rebound in productivity, I think the fundamental problem of low productivity growth will remain unsolved.

Q: *What about labor-management relations in connection with the productivity issue?*

Thurow: The problem there is that management can't seem to make up its mind about what to do with labor. Basically, there are two principal options: to arrive at some sort of cooperative labor-management arrangement such as you have in Japan or to take this opportunity to knock U.S. unions out of the economy and get rid of them. So far, there has been general ambivalence. Some industries, such as the automobile industry, are following the first option, and others, such as the computer industry, the second.

Q: *What is your opinion of the role of unions in labor-management relations and the revitalization of the U.S. economy?*

Thurow: There are two things to remember about unions in the United States. First of all, many industries don't have unions. In the private sector, only 13% of the workers belong to a union. Therefore, although labor-management relations are always important, unions are not a factor in many industries.

Even in those industries where there are unions, I think the unions themselves are trying to come to grips with the changing environment. In the context of global competition, you can only raise your workers' wages by raising their productivity. Traditionally, American unions have not been concerned about raising productivity, but some union leaders are now grappling with the problem of how to change their orientation and become actively involved in this new role.

Q: *Would you agree that in the last two years American workers have been less demanding than they were previously?*

Thurow: That is certainly true with respect to wage demands. It remains to be seen whether this will continue beyond the recession or whether things will simply return to the old pattern the minute American industry recovers. We will see soon enough, though, because corporate profits are making a very rapid rebound.

Q: *Some observers have noted that U.S. labor-management relations have also been strained by management top-heaviness. Do you see this as a general problem?*

Thurow: There is some truth to the charge that U.S. companies have become bureaucratic and management top-heavy. Private-sector payroll statistics show that the United States has 57 million white-collar workers and only 30 million blue-collar workers. Ways obviously need to be found to trim the white-collar bureaucracy.

Q: *What do you think the United States should do to improve its labor-management relations?*

Thurow: The problem is how to better motivate the labor force and build efficient economic teams among managers and laborers. I don't see the non-union industries doing much better than the unionized industries have.

One major obstacle is U.S. industry's high labor turnover. In U.S. manufacturing, the average labor turnover rate is 4% per month, which means that a manufacturing company loses about 50% of its employees every year. About half of that 50% is layoffs and the other half is people quitting.

That high turnover rate means that the average factory worker leaves a company after only three years. Naturally, management is not too keen on building good labor-management relations for the long term when very few employees will be around in 10 years. A lower turnover rate is prerequisite to getting people interested in the long-term future of their company. This is not only shop-floor workers. Managers are also reluctant to sacrifice for the good of a company if they are probably not going to be there in a few years. This "turnover mentality" is clearly one of the big problems in U.S. labor-management relations today, and there are a number of things that the U.S. government and industries can and should do to discourage it.

Nonetheless, I think the importance of labor-management relations has been exaggerated in the American context, probably because people look too much at Great Britain, where the British disease is clearly centered on labor-management relations. Labor-management relations are not the crux of America's problems.

Q: *So do you foresee a new round of wage and price increases in the near future?*

Thurow: I don't think that is an immediate problem. There are two things arguing against it. For one, America's inflation performance is not as good as it looks. The 1–2% inflation rate over this past year has included a 4–5% industrial rate of inflation that has been largely offset by falling prices for oil and food. But oil and food prices are not going to keep falling forever, and the minute they stop, we'll be back up to that 4–5% range, as many economists are predicting. Still, that's less than it was a few years ago. I do not think inflation will be much of a problem in the next two years, in either demand-pull or cost-push terms, because we still have a lot of unemployed people, meaning a lot of idle capacity, and I do not expect to see any food or oil crises arising in the near future. If anything, oil prices will go down.

"Becoming a service economy at the expense of industry is basically wrong"

Q: *What is happening in the United States in terms of retraining workers for greater productivity?*

Thurow: The U.S. needs many more retraining programs than exist, especially for skilled machinists and other highly-trained people. The real problem is that the large-scale unemployment in recent years has produced a surplus of trained people in almost every job category, and no labor shortage is likely until we get closer to full employment. So while there are definitely problems with the present training system, they have remained hidden under the mountain of surplus skilled workers.

Again, part of the problem is that industrial shifts often involve geographic shifts, so that retraining means relocation at the same time. And so in that sense, too, the retraining problem remains unsolved.

Q: *Productivity is also a question of plant modernization. How do you feel U.S. industry is doing here?*

Thurow: I think the automobile industry is doing a reasonably good job of changing procedures, cutting costs and improving product quality. The steel industry is another story. U.S. steelmakers have apparently decided to run their facilities into the ground while they move into other areas, such as U.S. Steel has done with Marathon Oil. There is very little evidence that America's steelmakers want to revitalize their industry, and, despite any advantages the American steel companies may gain by getting out of steel, it does not bode well for the U.S. economy.

Q: *Would you say that the U.S. economy is becoming a primarily service-oriented economy?*

Thurow: I think the size of America's service economy has been somewhat exaggerated. People have been drawing false conclusions from the available data. It is true that the data for new employment during the five-year period of 1977–82 show that 60% of all the people added to the U.S. economy went into the service industries. However, if you look at which industries those people have gone into, you will see that it is impossible for this trend to continue.

After all, 37% of the people who went into the service sector went into health care. At the moment, Americans are struggling to hold health costs down. Health care costs have risen from 5% to 10% of GNP in the last 20 years, and they cannot be permitted to double again in the next 20 years. Naturally, stopping this trend will also stop the growth of health care employment. Another 34% of the new service industry people joined consultant firms, with the result that we now have a glut of legal people and business consultants. Adding these two fields, about 80% of the growth in the service sector has been in areas where we know the expansion cannot continue.

Q: *Does this mean that the United States must turn back to its manufacturing sector?*

Thurow: If your manufacturing industries go down the drain, most of the services will go down with them. For example, look at British industry and British banking. When British industry declined, London's banks declined with it, albeit at a slower pace. Internationally-oriented banks must have a local industrial base, and I think that what has happened to the banks of London proves this. The idea of becoming a service economy at the expense of industry is basically wrong. ●