

Looking Back from the Year 2000

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If we have learned anything from the last fifteen years it is that surprises can occur and policy reactions will not necessarily be predictable or effective. No "world view" or scenario dominates for long. As a result, while economic forecasts have become easier to produce, they have become harder to believe. The sensible approach, put forward in this article, is to plan with sufficient variances for flexibility.

While only your imagination limits the number of possible scenarios, I have found a useful framework to include three broad scenarios: things get much better, things stay much the same (with remarkable volatility), and things get much worse. The first I call the BLISS scenario describing a world in which the pressing problems of the day are resolved. Of particular interest are the policies that lead to such an environment and the new challenges that arise in this "Valhalla". The DEJA VU scenario is an approximation to "current policies continued" or "muddling on". Unfortunately this usually becomes the Base Case view in most plans. Finally a COLLAPSE scenario completes the trilogy. This is usually triggered by one of the current problems getting worse and leading to a pessimistic outlook for economic growth, inflation, and/or some other component of the economy.

To make these possibilities more vivid and to encourage the empathic participation of the reader, I am describing these scenarios as a retrospective, written in the year 2000. In applying this approach to the global economy my supply of "paint" is limited for such a large "canvas". In the sections that follow I will have space only to sketch some of the most interesting characteristics of each scenario. The reader can color them in as desired.

THE BLISS SCENARIO

The world economy returned to some semblance of order with rising real incomes for most countries and a continuation of the growth of world trade following the deep recession of 1982-83. The changes in the last fifteen years have been remarkable; the doomsayers of the mid-1980s were proven wrong!

The key to world performance was the return to full employment in most industrialized countries by the early 1990s. The driving force was the reduction in real interest rates in the last half of the 1980s. This resulted in an economic expansion of the U.S. and other industrialized countries, led by business investment. Inflation has not been a problem since each country adopted a form of incomes policy. In the U.S. and Canada this took the form of a voluntary gain-sharing arrangement in which labour shared in the profits of each firm along the lines of Martin Weitzmann's The Share Economy. Some European countries adopted similar schemes; others used the broader "social contract" to the same end.

The rate of technical progress returned to a more normal pace of 2-3 per cent per year as labour markets tightened. It is now obvious that the productivity slowdown of the 1970s and early 1980s was an anomaly and a direct result of the economy not being close to potential. Managers and labour only find innovative ways for improving processes when they are under pressure to deliver with the otherwise fully-utilized resources under their control. Now it is commonplace for companies to have divisions to manage the adoption of new technologies, to reward the managers and employees with new innovations, and to market their innovations to other firms throughout the world.

The last fifteen years have not been without difficulties. In the early 1990s a major restructuring of the U.S. and U.S.S.R. economies was required as we witnessed an "outbreak of peace". The challenge was to redirect the talents and industrial capacity to productive activities. Most countries were able to accomplish this rather quickly; China managed the total conversion in less than three years. But the major powers had their difficulties, particularly with the switch to the production of competitive products by the defense industries. The emphasis on "firepower" did not help sell the initial deliveries of tractors! But by the late 1990s most of the major defense firms in the world had either failed or become major manufacturers of sophisticated machinery used throughout the world.

Government budget difficulties of the 1980s disappeared by 1995 in almost all countries as a result of lower real interest rates, the fiscal dividend of full employment, and the reduction in defense spending. Subsequent tax reductions have led to continued strength in real disposable incomes and gradual increases in private savings rates in most countries.

Many of the less-developed countries (LDCs) have emerged as major participants in the world scene. This was the result of the expansion of the old industrialized countries (OICs), the rapid adoption by the LDCs of the new technologies with the aid of the transnational firms, and three other important forces.

The first of these was the removal of the international debt burden in the late 1980s. It was finally recognized that the "Emperor has no clothes"; the LDCs could not repay the debts and the problem was ultimately laid at the door of the U.S. as a delayed consequence of their restrictive monetary policies during the period 1979-86. But the solution was elegant. The U.S. and other OICs bought the debt from the financial institutions for its residual value. In turn the LDCs agreed to exchange these debt instruments for goods that they produced. The developed countries distributed this debt as a form of international aid to many of the LDCs resulting in a substantial increase in trade between the LDCs and significant industrial development at the same time. The key was that each LDC received a package of claims on other LDCs that could only be redeemed through the purchase of goods from the debtor country. It only took a year before the LDCs were able to again borrow abroad. After all they were now debt-free! But the lesson had been learned; borrowing was restricted to servicing capacity and interest rates were linked to

international commodity prices.

The second development was a return of commodity prices to their long-term marginal cost of production. Part of this was an agreement by the LDCs not to subsidize their domestic production of commodities as part of their debt recycling program. This was welcomed by them in any case since it had proven to be an expensive approach to job creation! Even the world oil price, which collapsed in the latter part of the 1980s to under \$10 per barrel, had returned to \$20 by 1993 and is now a reasonable \$30 per barrel (year 2000 prices). Fluctuations still occur but they are minor and dampened by internationally managed stockpiles for most major foodstuffs, metals, and fuels. This development has been quite helpful to the resource-rich LDCs as well as to Canada and Australia. The consuming countries have also welcomed this stability. Of course buyers still complain that they pay too much and sellers feel that the price is too low; some things never change!

The third development was the expanded aid programs of the industrialized countries, sometimes as part of bloc political competition (a healthy substitute for military competition). This provided the bandages and time for the sustained growth phase in Latin America and Asia to take root. Progress has even been made in Africa, although it is still twenty years from "take-off".

THE DEJA VU SCENARIO

The last fifteen years have been tumultuous! We were so optimistic in 1986 when OPEC prices collapsed. It looked like a return to the 1960s. But we discovered that the effects were not symmetrical. The price collapse triggered some financial difficulties for U.S. banks and OPEC creditors. This in turn led to the continuation of high real interest rates. Governments used the weakness in price as an opportunity to increase energy taxes, further weakening the stimulus to the consumer sector. We ended the 1980s with double-digit unemployment in Europe and North America.

And then the problems began! OPEC was able to reassert its control on oil prices in early 1992. This was a result of little energy investment outside of OPEC after 1986. The start of the economic recovery in 1991 was aborted as governments moved to restrictive fiscal and monetary policies with a vengeance. The situation was made more desperate as those under 30 in most industrialized countries revolted in the streets and at the ballot box, in protest of ten years of 20 per cent unemployment or higher. They were joined by the elderly poor who had been one of the targets for much of the restraint in social programs.

The new governments in the mid-1990s did not find it any easier. The printing presses rolled, real interest rates declined, but with international capital flows still possible the flight of capital to several safe-haven countries proceeded along with the people who owned it. The depreciations were substantial, but not effective in restoring real growth. Inflation rates approached 30 per cent and the

unemployment rates still stayed in the double-digit range. The moves to share jobs and adopt more labor-intensive approaches have helped, but productivity levels today are no higher than they were in 1990.

Later this year (2000) an international conference has been scheduled to examine the need for some new approach to the international payments system in spite of some protestations that it is still working all right. But exchange rate variations of 50 per cent in one year have made a shambles of international trade, and wages still seem only to react to depreciations, not appreciations.

The less-developed countries have not fared well in the past fifteen years. The debt overhang is now approaching \$4 trillion, although no Western lender received any payment last year. Political support in the LDCs for any of the industrialized countries has virtually disappeared, although military aid is still accepted from the current major powers. The situation is fluid with seven revolutions in the last year, four of which resulted in pro-West governments and three moved to the Soviet bloc. Japan's "Co-Prosperity Sphere" now encompasses all of the Western edge of the Pacific Rim and extends to the Indian border. Japan itself has become increasingly reluctant to argue for liberalized trade practices in international meetings.

International trade has not grown from 1986 levels, and much of what takes place is intra-corporate or barter transactions. The LDCs (non-OPEC) have virtually dropped out of world trade; any foreign exchange earnings are quickly grabbed as partial payment for past due interest.

As we face a new century there is hope. The economists at Cambridge have a new plan; several OECD committees are considering another Concerted Reflation Action Plan for the next five years; and central banks promise a return to a stable economy as soon as inflation is under control. Will we get it right this time?

THE COLLAPSE SCENARIO

It's really getting cold again! I don't know when the lights will go out; electric power brownouts are a common occurrence. No time to provide a broad discourse, all I can do is jot down the headlines of the last fifteen years.

What was the trigger? LDC debt repudiation ... Domestic farm debt collapse ... Energy loans suspended ... Fiscal restraint in U.S. and higher interest rates cause Depression .

Perhaps it was all of the above, it's so hard to remember! But the consequences have been severe. No investment by private sector ... Fear of deficits prevented fiscal stimulus ... Changes in governments through ballot boxes and otherwise ... Massive movement into government securities, fear of repudiation of other instruments.

International trade has collapsed; capital flows seek safe haven currencies but the introduction of capital and exchange controls makes it difficult. There are massive famines in some LDCs and wide-scale rationing of food in others. Domestic turmoil and border threats remain a problem, requiring too many resources for the military.

Will we be able to sort out the difficulties? A capital tax is now being discussed seriously; but how effective will it be? There were only four capital projects this year and they were all government-funded prisons! Where have all the entrepreneurs gone?

CHOICES

From fantasy to nightmare! In these scenarios, events and outcomes are merely figments of imagination. And yet the year 2000 will arrive. We should all remember that the decisions affecting the type of world we will live in fifteen years hence have not all been made. The major reason for examining the future is to try to anticipate problem areas and to avoid them! This fits with Drucker's exhortation to look at "the futurity of present decisions".

There is another important caution to the reader. While considering various scenarios, keep in your mind the possibility of a "FFF" or "future fatal flaw" in any scenario. What could happen that would render the scenario useless or what can go wrong with the decision?

Given the wide range of possible forecasts, in the next several years it is critical that we address a number of issues and resolve them. Everyone has their own list; mine includes the following:

- o Real interest rates in excess of the real growth in the economy are dynamically unstable, lead to rising public and private debt ratios (and asset ratios), and result in the concentration of incomes that are a threat to the operation of democracies. A substantial downward adjustment in real interest rates is required in the U.S. and in most other countries in the world.
- o Europe, Canada, and many other countries are operating with substantial unemployment of their human resources and fixed capital. This waste dwarfs any other inefficiencies in the world economy. The challenge is to move much closer to full employment and quickly. This in turn will assist with growth in the LDCs and prevent a further widening of the gap between the "North" and "South".
- o Inflation is under control but at a very high price. Now is the time to consider broadening the policy package to include tools for the reduction of rigidities and/or more formal incomes policies.

- o The international debt overhang is not going to disappear. What is important is to handle it without jeopardizing the financial institutions in the developed countries. But the only real issue is the sharing of the debt writedown between shareholders and consumers.
- o The "experiment" with flexible exchange rates and the ensuing short-term capital flows responding to interest rate differentials has distorted the international trading system and forced many countries to pursue monetary policies that were inappropriate for their own economies. A move to a more stable system of managed exchange rates and coordinated interest rate policies is necessary if a world recovery is to take place and a major move towards protectionism avoided.
- o With these issues behind us, it will then be possible to focus our attention on the maldistribution of income internationally, the transfer of technology, and many other structural issues.

The construction of scenarios is the economist's equivalent of science fiction writing. The utility of the activity depends on the reader's response. George Orwell's 1984 alerted us to the importance of individual freedoms. The value of science fiction is that it sometimes causes us to act to avoid the prediction, and in other cases to realize the positive decisions required to reach our objectives. In the end, the future is not forecastable -- fortunately!