

The American Economy: Has it Lost its Way

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Steve Forbes
President and CEO, Forbes, Inc.

It is true that my brothers and I did get ahead because, unlike most people in the world, we were fortunate enough to pick parents who already owned a successful business. My father liked to say there's nothing wrong with nepotism as long as you keep it within the family. My grandfather founded Forbes, as you'd expect, people would ask him what's going to happen in the stock market? what stocks should you buy? where are interest rates going? what's going to happen to the bond market? and things like that. And my grandfather, being an honest individual, would invariably reply, "You make more money selling the advice than following it."

Concerning the American economy right now, certainly on the surface it seems to be a very troubled situation. We have trade deficits, budget deficits, income gaps, wealth gaps, mortgage market in turmoil, housing in turmoil, sub-prime borrowers going under losing tens of billions in the stock market. But the bottom line is the American economy, for all of its problems, is in fairly decent shape. It hasn't done badly.

Just to put it in perspective, we all know what's happened to India, we all know the rapid growth rates in China, but if you just take the growth rate of the American economy in the last four years, just the growth; the growth of the U.S. economy in the last four years exceeds the entire size of the Chinese economy. China is obviously growing at a faster rate, but it's coming off a very small base. The same is true of India.

In the last few years, we've seen an amazing productivity boom in the U.S. If you look at the growth and productivity in the first half of this decade versus the first half in the 1990s it's at twice the rate. And the productivity is not coming just from where you would expect it—in biotechnology and high technology—it's coming from everywhere.

One example, if there are any nutritionists here I apologize, but in Florida several years ago a group of franchisors from McDonald's decided to put kiosks in their facilities, the idea being that instead of going up to the counter you'd go to a kiosk and punch in your order which would save labor costs. They wouldn't have to hire as many kids at the counter to take orders anymore. They got the things up and running, and indeed they did save labor costs at the counter, but what they didn't anticipate was that the labor costs in the kitchen went way up. They had to hire more people because they're serving more food. Now, part of that, of course, is if you make it easier for people to go in, you get more traffic going through, but what they did not anticipate was that the per person order went up. They examined it from all different angles and they finally figured out why—kiosks don't stare at you. Think of that – at a certain age some of us get "metabolism

challenged,” and so this way you can super-size the order, order that extra milk shake and there’s no young kid looking at you with that look—it’s guilt-free.

What’s one of the biggest aggravations to traveling, other than getting through security lines or spending your vacation on a tarmac? It is when you get to the hotel, motel, resort, or wherever it is you’re going, there’s usually a line to register. They get you out quick enough, but getting in often takes time, and if there’s not a line it’s because they don’t have your room ready. Now more and more of these institutions are putting in kiosks. So, you go in the lobby, put in your credit card, and it spits out the plastic key. If you want to upgrade, or downgrade, you can do it in a matter of seconds. The first few times you do this, it’s very disconcerting. You go to your room and you feel something’s not right – you’re not mad, you’re not aggravated, you’re not swearing, it’s just disconcerting.

There has been an amazing advance in productivity as the numbers fluctuate from quarter to quarter, but it’s of historic proportions. Personal incomes in the U.S.—you’d never know it—are rising. In the last four years the U.S. has created more jobs than Western Europe and Japan put together, and you see the pattern repeating itself from the 1990s after the 1990-91 recession. First, profits from productivity grew, then in the mid-90s income started to catch up, started to grow rapidly. The same thing is starting to happen now. First productivity, profits are booming, doing very nicely. Now, personal incomes are rising as well. You see it on the corporate side, profits are at a record level, always beating expectations, capital expenditures by business, not great but not bad; hours worked in manufacturing, surprisingly going up not down; and there’s plenty of liquidity in the to keep this thing going.

On the corporate side, even though there are a lot of industries that have problems, and a lot of companies that have problems, if you look at corporate America as a whole, and take out their short-term debts, corporations in America, are plus \$2 trillion. Not since the mid-1960’s has cash made up such a large portion of the corporate balance sheets as it does today. You know the American consumers are portrayed as reckless spenders, living from credit card to credit card. Certainly, the headlines about what’s happening in sub-prime borrowing reinforces the image of a nation of reckless spendthrifts. But if you look at American households as a whole you find a very different picture. If you take what people own in stocks, bonds, bank CDs and money market funds, life insurance policies, 401ks, put all your financial assets together and subtract out what people owe, on their credit cards, on their mortgages—don’t even count the values on the houses or the apartments, just treat the mortgages as straight debt. So, you have financial assets on one side, debts on the other side, you subtract one from the other and find American households today are plus \$27 trillion. American households today have more savings, more financial assets than the rest of the world put together. So, we have a lot of problems but there’s a lot of under-appreciated strength, and if you add in what people own in their houses, even with the housing slump, add another \$25 trillion. In terms of credit card debt, half of American families have no credit card debt and those that do, the average is about \$2,200. So, if you look at the fundamentals, not bad, not bad.

What about some of the problems out there that we hear and read about? One, of course, is housing. Certainly, in a state like California, housing is right up there. We did have overheating in housing in 2004-2005 and part of 2006. We built probably in two years the normal housing starts you get in four years. There was a speculative bubble, but now the builders are running down their inventories as rapidly as possible. The thing that gets overlooked in all of the grim headlines is that sales of existing houses are not bad. It is housing starts that have collapsed temporarily but existing housing? You still have a market there. In parts of the country prices are

actually firming. Certainly in New York City some are inching up again. And, if you look at interest rates—the key thing in housing is interest rates—long-term mortgage rates, 30-year fixed rates are at 6.25 – 6.5. As long as those long-term rates don't shoot up we'll work this thing through fairly quickly. Inventories will be sold down, housing as a whole is not going to go through what happened to high tech after the bubble burst in 2000-2001.

Another problem we read about, of course, is Washington's deficits. Yes, they're coming down but the problem with Washington is not a lack of revenue, it is overspending. The revenue is gushing in and in most States you see it as well. The last two financial years in Washington, revenues have grown at a record level, but the problem is our wonderful representatives spend the money and then spend some more. It's like getting a \$10,000 raise and going out and spending \$20,000. That is a spending problem more than it is an income problem. Washington spending has been compared to that of a drunken sailor. Of course, that's an insult to drunken sailors; after all, drunken sailors are spending their own money, not other people's. But this truly is a spending problem. We have long-term problems with social security and with Medicare and Medicaid that can be dealt with without having a drastic decline in the standard of living.

One other thing we read a lot about, of course, is the trade deficit. What I'm about to say here will be controversial, but I think if you ponder it you will see some merit in it. First of all, if I was dictator of the world I would ban trade numbers—they just lead to a lot of mischief. Trade numbers are simply one of many factors when you gauge how an economy is doing. One of the biggest misconceptions is that trade is seen as profit and loss—if you have a trade surplus you're making a profit; if you have a trade deficit, you're in the red. Bogus analogy! Bad comparison, untrue. For example, in the Great Depression we had trade surpluses. We also had 25 percent unemployment rates. Germany consistently has trade surpluses and until very recently it was the sick man of Europe. Their economy was in, as Mr. Bush would say, deep doo-doo. It had real problems.

Trade numbers in and of themselves tell you nothing. Just to bring it down to earth – *Forbes Magazine* has had a trade deficit with its paper suppliers for 89 years. We consistently spend more with them buying paper than they do buying subscriptions from us. Now, why does this deficit go on? Because trade is transactions between two parties. Each party thinks they're getting something out of it. With us, the paper suppliers are selling what they make, hoping to make money. We buy it because we think we'll put something on it and that added value makes us money and serves our readers. So, the thing goes on because we each get something out of it. Take iPod. iPod imports most of its parts. Does that mean that America's going to the dogs? No. The value added is here. iPod has created thousands of jobs at Apple, thousands of jobs with retailers, added tens of billions of dollars to the equity value of Apple and made Apple a major player again when it was on the downslide. So, we're going to ban iPods because we import a big chunk of the parts? No. Trade is between two parties, each of which thinks they're going to get value added. This would put it finally in perspective.

This year marks the 400th anniversary of the Jamestown settlement in Virginia, which along with the Pilgrims a few years later at Plymouth Rock, started the American experiment. Well, in 400 years since Jamestown, North America has had a trade deficit for 350 out of those 400 years. Only between World War I and the early 1970s, did the U.S. ever have a trade surplus. Trade doesn't tell you, numbers don't tell you about innovation, inventions, new jobs being created, businesses being started, Google's coming along, eBay's coming along. It doesn't tell you about Intel opening up facilities in Malaysia which sells products to Japan, doesn't tell you about capital inflows to this country even though we have a population that is supposedly aging. The fact of the

matter is that even though the number of elderly in this country is increasing, so is the number of young people. Unlike Western Europe and Japan, we're still a relatively young country. When you look at China, they're a rapidly growing country, big population. They have a huge demographic problem with their one-child policy that they put in a couple of decades ago, they don't have a lot of young people coming along. They're like Western Europe without the development.

So, you can look at us compared with the rest of the world—problems, but not quite as drastic as some of the others have, certainly on the demographic side. Some of the things we read about, if put in perspective are not so bad. But as in any Garden of Eden there are serpents lurking around. Let me give you a couple of them.

One, of course, is the Federal Reserve—our central bank—now headed by Ben Bernanke. I know there's no more boring subject than monetary policy. If you're ever on an airplane, and you want a little elbow room as you're sitting on the tarmac, start talking to your seatmates about monetary policy, you'll have plenty of space. Think of monetary policy as you would your car; you can have a magnificent piece of machinery, but if you don't have sufficient fuel you're going to stall the engine, too much fuel you're going to flood the engine. Just the right amount, you have a chance to move ahead. The same is true of monetary policy. Economy fundamentals can be good, but if the feds don't supply enough credit, bad things are going to happen. That's what happened in the late 90s, the feds inadvertently didn't create enough credit and that helped contribute to the 2000-2001 recession. Now, three years ago the feds went in the opposite direction. They started to create too much money and so strange things are happening today—you see it at the gas pump.

Now, you say, "how do we know these guys are doing it right or wrong?" Economists gag at the notion of this, but the best crude barometer out there whether the feds are doing their job all wrong—don't look at money supply numbers, they're always changing—just look at the price of gold. Long story short, gold goes below \$300 an ounce, you're going to stall the engine. That's what happened in the late 90s. If it goes to \$375-\$425 an ounce, fine, the fuel injector is working just splendidly. If it goes above that level, as it did almost three years ago, just brace yourself, strange things are going to happen. It was Vladimir Lenin, who gave us Soviet communism that said, "The best way to undermine a social order is to debauch the currency." That's what he called inflation. Because, he said, not one in a million people will be able to diagnose what is happening. That is what's happening here.

When the feds start to create too much money, the first thing that always gets hit is commodities. So, you saw oil spike up, copper up, lumber up, steel prices up, shipping rates up, and no one knew what was happening. You read stories—it must be India and China buying a lot of this stuff, it must be greedy oil company executives—and finally, after 130 years oil company executives finally figured out how to manipulate the oil market. They're slow learners, but they finally figured it out.

In the 1970s and early 1980s you read these same stories—oil companies parking tankers off shore to manipulate the oil market, but no, the biggest villain is the Federal Reserve printing too much money. If you look at supply and demand in the world, put out the hype that the world's coming to an end, oil which was \$20 - \$25 a barrel five or six years ago, you'd make a case for maybe \$35-\$40 today. In other words, \$15-\$20 is inflation and that's speculation that's engendered by inflation.

So, long story short, gold remains at that level now—\$640 an ounce, and if it remains in that neighborhood just tighten your seat belts and expect that the distortions will continue. You don't necessarily get a spike in the cost of living but you do get distortions. Interest rates have increased fourfold, you overheated the housing market, sub-prime borrowers went overboard because the money was so plentiful, you see it in the hothouse atmosphere with the hedge funds and equity funds. Look what happened at General Motors, Ford and Daimler-Chrysler; gasoline prices shot up, they all went against the financial wall, Iran and Venezuela, two bad actors in the world, get windfalls to perpetuate that bad behavior. So just watch that gold price. That is one thing to watch out for. When you create too much money distortions are created, so just brace yourself for it.

Another challenge that is a constant one is taxes. One thing political cultures have a hard time grasping is that taxes just don't raise money for the government. Taxes are also a price and a burden. Think of it this way, the tax on income is the price you pay for working. Taxes on profit is the price you pay for being successful, tax on capital gains is the price you pay for taking risks that work out. The idea is very simple: when you lower the price of good things like productive work, you get more of them, raise the price, you get less of them. Very simple proposition but it's amazing how often that is overlooked. So, right now we read a new Congress is coming in, have to increase taxes. The tax cuts that were passed in 2003 which lowered the capital gains levy reduced the personal income tax rates, reduced the dividend rate, and gave incentives to small businesses to invest. If those things are done away with, and they expire in 2010, just brace yourselves, we're going to have a recession. The death tax, of course, is another thing that's supposed to expire in 2010 and come back in 2011. Only Washington would do something like that. So, a word of warning to you. In 2010 if your heirs suggest a trip to, say, Amsterdam, decline the invitation. The Dutch, among other countries, have legalized euthanasia. It's a scandal over there, but oftentimes they don't bother to ask the patient. So, if your heirs suggest a trip to Holland, just decline because you might just end up looking at the tulips from an angle you had not anticipated.

On the tax side, there's a lot of talk about increasing taxes to pay for tax cuts, but the bottom line is if you do tax cuts right the economy always prospers and the government always ends up with more revenue. The problem in government today is spending, not a lack of revenue. One of the biggest drains on the economy today is the Federal Income Tax Code. Just to put it in perspective: Lincoln's Gettysburg Address, defining the character of the American nation, 268 words; Jefferson's Declaration of Independence, 1300 words; Constitution, 5,000 words; Bible, 773,000 words and that took centuries to put that together; the Federal Income Tax Codes, rules and regulations, nine million words and rising and nobody knows what's in the thing. Even the experts at the IRS don't know; the tax collectors don't know. If you call their hotline, most of the time, 30 percent of the time, they give you the wrong answer.

Several years ago *Money Magazine* did a survey. They took a hypothetical family's finances, gave the numbers to 45 different tax preparers, experts in the field, and asked them to prepare that family's tax return. You know what they got back? 45 different returns, 45 different estimates of the family's tax liability—thousands of dollars in difference. Even the experts don't know what's in the thing. So, you look at a monstrosity like this and think of all the billions of hours we spend, all the anxiety, all the waste of brain power. I think the best thing to do, and at some point I hope we do it, as a number of other countries have started to do, is take the whole thing and throw it out and bloody well start all over again and get it right.

One solution to it, a favorite of mine, is the flat tax system, generous exemptions for adults and for children, family of four no federal income tax for the first \$46,000 of income and only 17 percent

above that, no tax on savings, no death tax. You should be allowed to leave the world unmolested by the IRS and as our founders would say, “No taxation without respiration.” On the business side, reduce the profits taxed from 35 percent to 17 percent and do away with depreciation schedules. If you make a capital investment, write it off in the year in which you spend the money; if you have a loss, carry it forward against future profits until the thing is used up. If you do that, you’ll see this economy take off like a rocket.

Let me just quickly hit on the two big things out there—Medicare and Social Security. On the Social Security side. First of all the trust fund doesn’t exist, it’s a fiction. It’s not like a real trust fund. There’s no money in there, just IOUs. When the money goes in, surpluses go in from the tax and it is spent immediately. Have no illusion on this, there is no 401k there. If you’re above the age of 50, we have enough wealth in this country to pay the benefits. We don’t have to change anything, so people who are on this system or about to go on in the next ten or 15 years, no problem. The real problem comes in with the younger people. People in their 20s and 30s. That’s when the pay-as-you-go system is going to have real problems. The answer is to allow young people to have their own personal accounts. You can have restrictions so that they don’t go into gold mines in Burma and sink like that, get into broad-based diversification like the federal thrift plan for the federal government where millions of people participate. You turn what is a liability into an asset. People at a young age, as soon as they start earning money, they’re going to have money set aside, capital creation, wondering where that’s going, how do you make it grow? what are the conditions that make it grow? Good healthy habits and the economy will be stronger. Money is invested in the economy instead of bridges to nowhere and that way you have a stronger economy and you have a better population and you have a country that is a beacon of people who want to get things done. I don’t know why we don’t do it. We can do both—pay off the old obligations and have a system that will give people more.

People say, “What happens if the stock market crashes when I want to retire?” Well, you can give them this choice: When you go on this system with personal accounts, you should pick your retirement date – if you want to do it at 60, fine, if you want to do it at 98, fine. And when you retire you should be able to choose taking the annuity from your own personal account or what Social Security would have given you. Pick the higher one—I guarantee you that in 100 percent of the cases the personal account annuity will give you more than the current system can possibly give younger people. So, give them a choice so that way they don’t have to worry.

Finally, on health care. Ask yourself why we have a health care crisis. Yes, they say we live longer. I think that’s an opportunity. I don’t think longevity is a crisis now—my heirs might, but I don’t. The basic problem with health care is the crazy way we finance it. It’s third party. We don’t get the normal market forces at work and this is where these health savings accounts can get some of the obstacles out of the way and can work. You can get real insurance, real catastrophic insurance at a very affordable cost. We do it at our company. Each year people get \$2,500 for medical expenses and what you don’t use you get to rollover and earn interest. If you go above the \$2,500 only then does the deductible kick in, and if you go above the deductible then you have the catastrophic insurance. Our costs have gone up less than our peers. Why? Because suddenly it’s not my money, the insurer’s money, the government’s money. It’s their money. Guess what? People try to get value for their money.

Look at the cost of surgery on your eyes. Millions have done it. It costs half of what it did ten years ago. Why? Because it’s usually not covered by insurance, so providers have every incentive to make it more affordable. You, the consumer, have every incentive to get value for it. It works. This way you’re not taking away from people. We find it’s cheaper to buy a high

deductible policy, give most of the deductible to people. We still come out ahead and they feel they're more in control of their lives. Why not do that with Medicare? Have catastrophic coverage to give you more coverage than you do today so that you don't have to have all this supplemental insurance and you control the money. If you're blessed with good health, it accumulates, you have money for routine expenses and you're covered for the catastrophes. In essence, turning liabilities into assets.

So, bottom line with the American economy—we have a lot of challenges out there, a lot of problems, but there are very, very fundamental strengths. If we make some of these positive changes and play to those strengths there's no reason why we can't move forward and grow and show the world that even as we fight the forces of darkness in the world we can grow and expand at the same time.

Thank you very much.

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