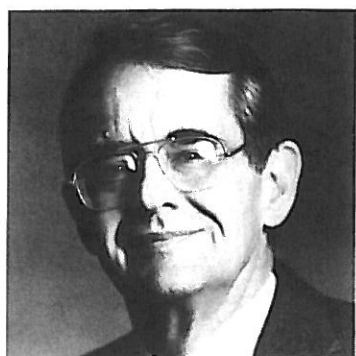

PROFILES AND PERSPECTIVES

A Conversation with Pete Peterson



Peter G. Peterson

During his professional career, Peter G. Peterson has observed movements in the U.S. and global economies from several different perches. The Nebraska native now chairs the Blackstone Group, an investment banking firm in New York City. He also is head of the Council on Foreign Relations. In 1972, Peterson, son of Greek immigrants, served as secretary of commerce under Richard Nixon. And from 1973-1984, he was chairman of Lehman Brothers.

In 1987 Peterson's financial and political involvements prompted a book on America's economic future. "On Borrowed Time: How the Growth in Entitlement Spending Threatens America's Future" presents his case for economic reform. His plan starts with reducing middle and upper class entitlement programs.

*In this interview in his Park Avenue office with **Forum** editor Bill McKenzie, Peterson contends that America "has a progressive type of economic disease." The New York banker says that we are not looking at economic issues over the long-term, and that Wall Street would respond favorably to a tax plan that includes serious entitlement reductions. Peterson also discusses Eastern Europe and Lech Walesa, who recently made an appeal to Peterson and other New York financial leaders for investment in Poland.*

Ripon Forum: In 1987 you wrote that "Americans are about to wake up to reality: for some time now the foundations of their economic future have been insidiously weakening." What does this mean? Is it still true today?

Peterson: The article was titled, "The Morning After," but I really meant the piece to be about the next decade. In a world where capital flows are overwhelming trade flows by 50 to 1, no one can predict what's going to happen from month to month or year to year. So much depends on the psychology and, to some extent, the politics of the foreign lender. But I have never seen a study of long-term economic performance that did not show investment to be a major factor in determining success. We not only see a high savings and investment rate in Japan, but also in the successful, so-called newly industrialized countries of Korea, Taiwan, Singapore and Hong Kong.

My concern is that when you start with our very low savings level, which is more like a puddle, and consume from 60 percent to 80 percent of that savings rate on the deficit, a pitifully small portion is left for actual investment. Our ability to regain economic momentum depends on an investment level that we cannot fund from net national savings.

Our current account deficits, for example, run roughly two and a half to three percent of gross national product. In the late 1800s that rate was one and a half percent. But a great deal of money

was being spent on investments such as railroads and steel production. Within about two decades, we had paid that extra debt back.

Ripon Forum: Let me play the devil's advocate a moment. The economy is running at near full employment, inflation remains low, growth in GNP continues to outstrip growth in the deficit. So why worry?

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Peterson: A great deal of the deficit is being financed by foreign capital, which leaves us vulnerable to foreign whims. The metaphor I would use is that we have a progressive type of economic disease. If you look at our economic problem over a period of decades, which I am urging us to do, it is hard to believe that we would not get agreement that there has been a qualitative change in the strength of our economy relative to the rest of the world.

The notion of competitiveness includes many factors, but a competitive work force and a competitive education have to rank very high on the scale. Al

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Shanker of the American Federation of Teachers told me recently that somewhere between 20 and 30 percent of kids cannot handle change from a two-item check in a restaurant or write a coherent sentence. They are functionally uncompetitive for the mix of future, knowledge-oriented jobs.

Shanker also pointed out that as significant as the problem is at the bottom of the pile, the top five percent or so of our graduates in math and science equal the average in Japan. The vast majority of our high school graduates would have real trouble getting into a major foreign university.

Ripon Forum: That is what the head of a teachers' union said?

Peterson: Yes, that's my point. If you talk about what I call the "investment agenda," many people would say that education and training have a significant competitiveness deficit.

Many would also say that our infrastructure is crumbling, which is almost becoming a cliché. Look at our public investment in bridges and highways. This cannot continue. It's almost embarrassing to walk down the street in New York. Water mains are endlessly breaking and streets are cracking.

I just returned from Japan, where I saw both their subways and bullet trains. Indeed, I went from Osaka to Tokyo in a little under three hours, and at 135 miles an hour you could barely hear the trains.

Japan's business investment is substantially larger than ours, with half the population. They have about two-thirds of the world's robots.

So there are a variety of areas -- human, public and private -- where investment is required to regain our competitiveness. The melancholy fact is that

the political system pervasively evades the resource problem. There is endless political chatter about the new cliché -- "regaining competitiveness" -- without facing what we are prepared to give up to get it back. The brute questions are: Whose consumption is temporarily cut? What particular spending is needed?

If you walk down Fifth Avenue in New York, you typically see young men playing a game called "three-card monte." The aim is to try and guess which one of three cards has money underneath it.

If you stop and think about it, our political economy is like three-card monte. The president, and Washington generally, says there is a drug "scourge," the environment is a high priority problem, and education is a "crucial" issue. But when we discuss resources, both parties, Congress and the Executive Branch start the shuffling process.

Ripon Forum: So what's your answer? Congress is reluctant to pass serious deficit reduction packages, and President Bush has pledged not to raise taxes, partially out of a belief that Congress would spend the extra revenue.

Peterson: A group of us ex-Cabinet sorts got together several years ago and I was astonished how quickly we agreed on the problem -- increasing net savings -- and how obvious the solution was -- moderation in the growth of defense spending around a more coherent definition of our needs and slower growth in entitlement spending. Spending reductions are the top priority, and these reductions must be linked in an iron way to any consumption-based tax increase, such as a gasoline tax.

Over the last 25 years, the increase in entitlement spending has been larger than the entire defense budget. That's just the increase! I became exorcised about this fact, and spent three years working on a book about the subject. In President Reagan's words "we ain't seen nothin' yet."

With a rapidly aging society, with people living much longer, with a seriously flawed health care system, and with 100 percent cost of living adjustments (COLAs), we could easily end up with entitlement spending increases 50 percent larger than the current numbers.

The tax rate to support that increase would be economically, politically and morally impossible vis-a-vis our own kids.

If you moderate COLAs to 60% of the CPI until the year 2000, you would save over \$100 billion in entitlement spending per year.

Ripon Forum: So, as you write in "On Borrowed Time," we should tax Social Security benefits for middle and upper income recipients?

Peterson: You also have to limit cost-of-living-adjustments for the non-poor. The annual COLA increase next year will be between \$12-14 billion. If you moderate that to 60 percent of the Consumer Price Index until the year 2000, you would save over \$100 billion a year. That's what Everett Dirksen would call "real money." It is profoundly important that our budget reform be long-term, structural and ultimately credible and persuasive to financial markets.

As far as Social Security benefits go, people in my income category are getting back substantially more than we put in to the system. It's welfare for the wealthy. I do not understand the

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morality of this. In a time of fiscal stringency, why should upper income people be receiving welfare -- tax free, incidentally?

We ought to tax Social Security benefits for people over a certain income level who have received back the amount they contributed to the system. And I think we ought to tax it 100 percent. That is where I am on this subject.

Ripon Forum: If we have a Congress

that only reluctantly put together a \$14 billion deficit reduction plan, and usually relies on the automatic Gramm-Rudman-Hollings device to cut spending, how can we expect it -- or the administration -- to take the lead on these kinds of issues? As you've also written: "At bottom, our problems are not economic. Rather we are stymied by our lack of political consensus."

Peterson: It's a bit like a turkey shoot. Everybody says to people like me privately, "Pete, we know you are right. We have to do something about entitlements and the deficit. We need some revenue increase. But I'll be damned if I'm going to be the one that proposes something just to get my head shot off in the process."

Japan and Germany's real competitive edge is their long-term economic consensus, which we sadly lack. To be sure, their consensus may have been born out of crisis: the Germans profound fear of hyper-inflation and Hitler, I suppose; and the Japanese because of the destruction of their capital stock during the war and their need to become more productive given their lack of resources.

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But the Japanese have a rapidly aging society, too. Yet a 1986 study put together by their equivalent of our health and welfare secretary said that there were profound issues of inequality in their society, that it was too much of a burden on the economy, and that it was too unfair to the nation's children. So Japan decided to reduce their elderly benefits by 20 percent over a period of time. There was hardly a public wimper.

Recently, Japan also came up with a program to stimulate domestic demand and imports and infrastructure investment. The government issued a report, the parliament acted on it, and now they are getting annual results.

Ripon Forum: But we do not have a tradition of government planning in the

United States.

Peterson: The last thing I am proposing is planning. But both the Japanese and Germans have certain economic fundamentals that should be bipartisan in this country. For example, without productivity improvements, real wage growth cannot occur and inflation cannot be kept under control. Moderate increases in the money supply and moderate wage increases related to productivity are also important. This is not national planning, just basic economic sense.

Our allies criticize us for not having an agreement on even the most fundamental principles of growth. We do not have a long-term consensus nor a system that can make genuine trade-offs or choices. Some other societies understand that if you want more of this, you are going to have give up something and have less of it for a while. That is the opposite of our "you can have it all." The incapacity to make choices that involve costs is at the heart of our problem. The consensus is all rhetoric and little action.

Special interest groups in other countries also are sublimated to some larger and longer term sense of the society's interests. In our case, the most powerful group is the "grey" or elderly lobby. They strike utter terror in the political system. We saw it recently in the catastrophic health care revision, where even the principle that the well-off should pay for the program's benefits was considered an anathema.

We all want to get on the wagon. But we do not have a notion of who does the pulling and what the costs are. Many of our allies want to know whether it's going to take a crisis to make us consider this.

The answer is to come up with a positive vision that is not imposed by a negative authority. Our leaders need to point out a vision of this country which says that if we make some choices, that vision could be obtained. But we are not getting that kind of leadership. We are not getting an honest discussion of our symptoms and of what real long-term health would be like. I believe the American people are genuinely concerned, in their gut, about our economic future and competitiveness. They are ahead of our political representatives on this.

Ripon Forum: Is government dead, as *TIME* Magazine asked a few weeks ago?

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Peterson: I don't know if it is dead; it is certainly paralyzed about making any real choices.

Ripon Forum: Let's switch to Wall Street. How would it respond to a variety of tax increases, such as a gasoline tax or an oil import fee or an increase in alcohol and cigarette taxes?

Peterson: Curiously enough, I think confronting COLAs and entitlements as part of a comprehensive budget reform package would have an electrifying effect on the market. From talks I've had with people on Wall Street, if you presented a long-term budget package that look balanced -- one part tax increase but the larger part structural spending restraints -- the median response is that bond rates would fall two full points.

Remember our real interest rates are extraordinarily high, as are our capital costs. High capital costs impose a high hurdle people have to jump over to rationalize investment. It would be very useful for politicians to go to Japan to understand the great advantages of having a lot of savings. As the supply of savings goes up, the cost of capital goes down. We need a payoff for our investment, due to our high capital costs, in half the time.

Ripon Forum: How should the rest of the United States, not to mention the world, view developments on Wall Street over the last couple of years? Are these periodic "black" days a mere series of jolts and corrective measures, or are they reflective of a potential for a future Wall Street earthquake?

Peterson: The cliches that started in the '60s about global economic inter-

dependence are now coming true. Our capital markets are becoming remarkably intertwined. When you are dependent on foreign capital to fund current account deficits, a perception abroad can radically affect our stock market and economy.

For example, a couple of big Japanese banks looked at the United Airlines leveraged buy-out and concluded, prudently, I might add, that it was "all takeoffs and no landings." Within a couple of hours the decision of those two Tokyo banks led to a \$200 billion fall in the value of stocks on the American market.

The exchange rate is dominated by whatever capital does around the world. Foreign capital flows are at the heart of what happens in the economy.

It is awkward to stand tall while on bended knee, which is the ambivalent situation we are now in. We talk about autonomy, but the destiny of our economy is shifting abroad.

Ripon Forum: How will the business community respond to appeals for investment in Eastern Europe, in par-

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ticular Poland? What should be our public response?

Peterson: A stark analysis of the Polish economy is that the country is in the wrong industries. I'm not at all sure that shipbuilding or steel production should be a major industry there.

The Polish problem is one of restructuring into areas where their economy has a competitive advantage. Lech Walesa was in New York recently and I happily co-chaired a dinner for him. I told the group that among this terrific leader's heroic acts was the taking of

positions that are remarkably difficult for a labor leader. This includes asking workers to give up subsidies and temporarily restrict certain shops. Imagine trying to explain the positive outcome of those moves to your members.

Somebody once said that an economist's lagtime is a politician's nightmare. If Poland's transformation takes ten years, and during several of those years progress is absent or even in decline, the question is, will its political economy be able to sustain it?

I guess the attitude of business people here will be very selective. They will want to make sure that wherever they put their money, there is a competitive advantage. Too many experiences in that part of the world during the 1960s and 1970s were pretty costly. This time, let's hope that any public financial support is genuinely linked to real market reforms. As Lech Walesa told me, "our system is kaput." ■

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