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38TH ANNUAL LECTURE TO ICAF

by Leo Cherne

In a number of fundamental respects, the State of the Union is more troubled than at any time, but two, over the period of 43 years since I first addressed the able men and women who comprise the military and civilian members of the class of the Industrial College of the Armed Forces.

The first such occasion began these lectures -- that was 1939. At least the European shores of the civilized world were entering the shadows from which the possibility of a continuation of western civilization as we had known it might not again reenter what Winston Churchill called "the sunlit uplands." In Nazi Germany and Mussolini's Italy, in Imperial Japan and, in a less pronounced manner, in Franco's Spain, western life and culture were under lethal challenge. Here in the U.S., I don't think I put it too harshly when I say we were in isolationist flight from responsibility and reality. We clung to the illusion of the safety of our protecting oceans, intent on avoiding the corruption of muniitions makers, war mongers, alliances, commitments and still antoher involvement in Europe's troubles. Our military capability was slight, our preparation for industrial mobilization in the event of war was required by law, but unfunded by the Congress and frowned on by the Secretary of War.

Within the months that followed, England alone survived Hitler's blitzkreig while we found ourselves progressively emotionally involved in England's cause, yet determined to avoid full association. The world had not seen, not even inn Napoleonic days, so invincible a military machine

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as that which had been assembled by the Nazis and hardly less true of their Japanese allies in Asia. It is impossible to look back without concluding that it could have gone either way for all of Europe, including England, had not Hitler betrayed his Russian allies and had not Japan assaulted Pearl Harbor.

A threat of profoundly different character occurred in the 1960s. Stimulated by the war in Vietnam but encompassing a great deal more than a native opposition to that war, the U.S. experienced the greatest challenge to virtually every form of authority. The hammer blows of a revolutionary generation of the young swept along with them perfectly respectable segments of American political life. That convulsion, which approached its high point beginning in 1965, climaxed in Chicago in 1968 and was not to subside until a President had been driven from office and another President, who presided over defeated withdrawal from Indochina, encouraged a morbid assortment of behavior we lump together under the description of "Watergate".

I've, of necessity, vastly oversimplified both of these episodes as I approach today's State of the Union. Our present state is a mixture of strong and weak, favorable and threatening.

Today's State of the Union is the product of decades of increasingly sterile policies. But it is much more than that. We are in the midst of a profound change of the American econnnomy occurring within the context of even larger change of economies overseas. I am delighted I am making this tenuous assessment at this particular time if only because there appears to be incresing evidence that we are safely past one threshold -- in some ways, the most far reaching, economic distress since the Great Depression. The economic seers cluster on the bridge searching for the fist signs of recovery.

If they are right, and I join them, the long, sought shore appears to be visible in the distance. Few expect a dramatic landfall. The exit out of the recession is expected to be slow and unimpressive. Indeed, the most notable change in economic expectation which has occurred within recent weeks is that the fear that the recession would develop into a full blown depression now seems to have faded.

Dramatic and favorable changes have occurred within the last 12 months. What is most notable is that these favorable changes do not appear, as normally would be expected, to be a harbinger of a period of great promise immediately ahead. The first of those changes, a 33% drop in the prime interest rate from a 21% peak to 13-1/2% and heading lower, is massive. Related yet separate, the reduction in the rate of inflation almost in half, from 11% to this year's likely annual average of 6%, should by itself induce a striking economic response. A gathering of some of the most distinguished economists, representing a wide spectrum of views at a meeting of the American Assembly two years ago, agreed that if inflation were brought down to 7% it would have been brought down to that level at which the public perception of a continuing inflationary threat would no longer encumber the economy.

Except for the efforts to compensate for years of cumulative neglect of our military capability, the size and reach of the federal government has undergone the first reversal in the peace time portion of the last 40 years. Tax incentives have been put into place and they remain essentially unchanged by the tax revision recently passed which provide substantial incentives for business growth and somewhat less incentive for an increase in savings. Yet business does not grow, nor have savings in any significant way been increasing.

We face the debilitating fact of a 10% rate of unemployment with little likelihood that we will see an early reduction in that figure or the much more painful level of unemployment among America's minorities and, in particular, those who are young and, for the most part, uneducated and untrained.

Yet, these are not the truly troubling signs. Those troubling signs are what leads me to include this period among the three occasions in more than 40 years which significantly challenged our society. What concerns me is that we will clearly have emerged from this recession at some point in the coming months, but that we will continue to find intransigent certain structural changes in our economy. I am especially concerned that we will almost certainly see more clearly, when the recession is over, that critical segments of basic industry are in crisis. Almost all of manufacture could be included in this generalization, but I am concerned in particular about four segments that have in the past been fundamental to the health of this country, to our economic power, to the overseas reach of our industry, and to the generation of vast employment, including employment opportunities for the highly skilled but less educated. Those areas are automobiles, housing, steel and machine tools. Of these, it is likely that a significant reduction in home mortgage rates will fuel a great recovery in home building. It is at least, the most sheltered among these four major industries from the effects of overseas competition.

But much more than interest rates are involved in the prospects for the other industries I have mentioned. Automobiles, steel and machine tools are very much the object of international competition, aggravated by the welter of trade barriers, tariff and non tariff, of preferences, subsidies, the availability of cheaper capital and the increasing ability throughout the many industrialized nations to manufacture goods of comparable or even higher quality more profitably and at lower cost.

Strip away all of the unfair barriers. Imagine the freest exchange of trade and we are still left with the remorseless operation of what economists always reason as the Law of Comparative Advantage. That advantage is not enjoyed by us. Change is, of course, always painful to industries whose unchallenged eminence has come and gone. It is more than painful, it is tragic to the great number of those who have been employed in those industries, who can neither readily tear up roots nor find alternative occupations for which they are equipped. Such change may even, in the most fundamental sense, be beneficial -- an inevitable consequence of progress and evidence that the U.S. has learned to do other things better.

It is difficult for a nation to bemoan the decline of its manufacture some 20 years after it was already first evident that we are now becoming a service society and with, depending on what is included, between 55% and 70% of our employment now generated by the host of services which make up our national economy. There is a poignant irrationality to our welcoming the stature and ease of the white collar occupations while bemoaning the decline of the grimy and physically demanding occupations. Yet, there are nagging anxieties about this change, one of them of particular moment to you.

If our service society were providing nearly full employment, we, nevertheless, face the painful knowledge that national power, including the civilian base for vital military capacity, requires industrial strength.

Within the last month, at a time when we were at the bottom of our recession, new imported cars took more than a 30% share of our domestic market. For us it was the worst of times, for Japan, recession or not, it was the best of times. In just two months, imported cars into the U.S. had risen from 24% to 30.6%, while domestic automakers saw their inventories of unsold cars rise from a 52 days supply on May 31st to a 79 day supply in the middle of July. Of those imports, more than 80% were Japanese. Meanwhile more U.S. companies have failed within the last months than in 50 years.

A change which will ultimately be of far greater magnitude than our crisis of manufacture is the very real threat to the eminence the U.S. has long enjoyed in high technology. In some respects, the Japanese threat to existing industries, dramatic as it is, is dwarfed by its achievement in several high technology areas.

The Japanese accomplishment in the field of consumer electronics has been simply astonishing. Bear in mind, whether we talk of citizens band radios, color TV sets, or the mushrooming market for video tape recorders, that the technology involved was only recently our virtual monopoly. Search, if you will, today for a TV set or video tape recorder, whatever the trade name it carries, which wasn't "Made in Japan". The markets are large, but the consequences of this market loss are limited.

That is not true, however, of the critical areas now under challenge — micro-electronics, robotics, aerospace, biogenetics, telecommunications, including fiber optics, and, ultimately of greatest importance, the advanced computer. Even now, one of the nightmares of military planners is the possibility that by the end of this decade, command and control will depend on communications equipment made in Japan.

I cannot, in the course of this overview of the State of our Nation, satisfactorily summarize the enormity of the advantages enjoyed by Japanese industry. Export and survival are synonomous in the Japanese economic culture. The competion between the two of us would be infinitely easier if American industry had at its disposal the funds for investment which are available in Japan at the rate of interest they pay. The relationship between U.S. industry and government is historically, and in the best of circumstances, adversary. There is no parallel in the U.S. for the coordinating, cooperating, planning, stimulating and supporting role played by MITI - the Ministry of International Trade & Investment.

One interesting sidelight better illustrates this difference between our economics than alost any other I know. It describes the chasm between a cooperating society and one which depends on a host of adversarial protections. In Japan, there is approximately one attorney for every 10,000 people. In the U.S., one attorney serves 450 people. The Japanese culture abhors litigation. Last year more lawsuits were filed in California than in all of Japan. There are more lawyers in Los Angeles than in all of Japan.

I can recall to this day the profound surprise when I was assigned the task, by General Douglas MacArthur, of revising the Japanese tax structure. I learned that the imposition of Japanese taxes involved individual negotiations between members of the tax collecters union and the taxpayers from whom they sought tax payment.

The strength of our democracy rests to a great extent on the vital concept of countervailing power. Virtually all of Japanese life and, most of all, the management of its industries, rests on dialogue, consensus, compromise and interaction. But these are no longer exotic cultural peculiarities. There is a sizeable question now openly expressed by the heads of America's major semi-conductor fabricators -- can our kind of a competitive system successfully contest state economies? Japan Incorporated is not just a figure of speech.

Only in contrast does the economic structure of Germany, France, Italy, and Belgium seem unstructured and free.

Several months ago, in order to more effectively stave off Japanese competition, the manufacturers of semi-conductors announced plans to expand university research contributions by the industry to 20 million dollars over the next two years. Only last December, five million dollars seemed adequate. Let me suggest that the 20 million dollars won't solve the problem, not when Japan each year, with half the population, graduates more engineers than we do. Even that number is still not adequate to meet the Japanese requirement. Engineering need has begun to sink into the consciousness of our career seeking young. There is even some question whether we may not now be attracting a sufficient number of engineering students. But that does not obscure the fact that we do not have an adequate engineering faculty nor do we have adequate university laboratories and equipment. And 40% of our engineering students are foreign nationals.

The recession we have been through will do much to reduce the lethargy, the complacency of our competitie thrust. However, one additional fact, when it seeps through, may do more to excite an adequate U.S. competitive response. The U.S. world standing in per capita GNP continues to fall, slipping from first place 10 years ago to 14th place by 1980-81. Ten years ago the U.S. still stood way out in front with the largest GNP. By 1977, the U.S. had fallen to fifth place in per capita GNP. That placed it behind Kuwait, Switzerland, Sweden and Denmark.

Today not only the oil-rich, people-poor nations supercede us, but also the highly developed countries in Europe, including allies. Forgetting the oil rich countries, immediately below them and well above us is the country of the troubled clock makers, Switzerland, with a per capita income of $16,400; Germany with $13,600; socialist Sweden with $13,500 and both France and The Netherlands above our per capita income of $11,360. Our per capita GNPP of $11, 360 is only a bit bigger than Iceland's.

I have said that our State of the Union now is a troubled one. I will quickly sketch some of the major additional troubles. How undramatic it sounds to say we have a banking problem. In fact, we have several banking problems. Three is a crisis of the Savings and Loan institutions which have been carrying massive numbers of mortgages owned by homemakers who incurred their debts at a time happier for them but not for the banks. We have the shock of the Penn Square disaster. But of far greater consequence, is the enormity of American banking loans which have been made to the less developed world. We are deeply involved in the more than 80 billion dollars owed by the Government of Mexico. The European banks are equally deeply involved in the economic mess that is now Central Europe which also has an 80 billion dollar debt. And the international banking system is inseperable. Damage one of us and we are all in crisis. An aphorism youu have surely heard which is worth repeating -- if you owe a bank $10,000, the bank owns you. If you owe a bank $1,000,000, you own the bank.

The crisis of liquidity is not limited to banking institutions. For the first time, social security will have to borrow up to seven billion dollars before the end of the year to meet its obligations. The pessimism expressed in the following bit of data is almost certainly warranted, but it is not unimportant. "Seventy percent of the American people do not believe social security will still be here when they retire." As the Social Security Commissioner remarked: "It is that same group of people whom we are going to have to rely upon for payments to keep the system going."

The national psyche is not elevated by lerning as it did on July 20th that our nation now enjoys the highest rate of poverty in some 15 years -- one person in every seven. But the growth in poverty is mirrored by another kind of poverty which affects all of us. The alarming decay in the nation's infrastructure, its roads and bridges, sewers, transportation systems. The U.S. Steel Corporation contends in Pittsburg that it is paying at least one million dollars a year to detour its trucks 26 miles around a major bridge that the state of Pennsylvania closed tow years ago for lack of repair. In the city of which it used to be said that its money had not yet been counted -- Houston -- Texas Monthly reports at least that it HAS counted one and a half million potholes. I have the doubtful privilege of living in a city in which its water is brought in an underground aqueduct constructed more than 100 years ago. That aqueduct has been crumbling. When New York faced bankrupcy some years ago, repairs which had begun were discontinued.

Do I plan to leave you with this catalogue of misfortune, unbuffered by appropriate doses of valium? What, in fact, was my plan beyond this assignment I have performed annually for a period that runneth longer than the memory of man? Quite candidly, as I said at the very beginning, I do not believe one can describe today's State of the Union without dealing with the shocking fact that we have let years slip by while our productivity declined -- our manufactures became increasingly less profitable or moved overseas — our social services ran rampant -- the excellence of our educational institutions declined in almost exact proportion to the increase of the students seeking that education.

No single dramatic event damaged our competitive thrust. No single circumstance produced the progressive reduction of our share of world trade. It is bizarre to think that the most heroic of measures would, in the space of two years, arrest this decay let alone reverse it. If there is ever a time when it is urgent that the meaning of all this bite in, it is when things seem bleakest, before the euphoria of the biggest week in the stock market's history begins to cloud our vision and dull the sense of urgency. The awareness of our reality must be deeply rooted before the recovery in our economy, which will come, will quiet the ache and obscure the challenge.

Let me confess that there are a host of promising bits of data, harbingers of a better day. After all our GNP did in the last quarter rise by 11/3%; personal income was up by 1% in July; new housing starts in July surged to the highest annual rate since April 1981, a 33% increase in just one month. The fall in consumer loan rates beginning to occur, it will speed up. The U.S. government has announced the second reduction in two weeks of its interest rate ceiling on federal home loans. Even new orders for durable goods rose by more than 3% last month. The Defense Department acknowledged last week that it has begun a five year, 100 billion dollar program to enhance the ability of the armed forces to sustain themselves in combat. We now have an estimated 30 day combat supply.

Can you imagine the liquidity, the sheer volume of available money that is lying in wait when you realize that 450 million shares of stock were sold in one week! Foreign capitol is well aware of our potential and safety. Foreign investments in the U.S. grew by a record 31% last year.

It is not for nothing that the IMF pleads with us and all the nations of the West not to relent in our continuing struggle against inflation, warning that a further reduction is essential despite the high human and economic cost attached to inflation-fighting policies. In some degree, even the disarray among our allies is less a reflection of our behavior and policies than of their distress. As George Will recently said, "Our allies love us. We are their floating alibi." Here's one day's headline this week on a newspaper's financial page: "A World On The Brink Seeks The Dollar".

If we need any balancing sense of promise to mitigate the catalogue of difficulty I place before you, let us now recall that American output is 35% of the industrial world's total production -- that 80% of the world's foreign exchange reserves are held in U.S. dollars. The unbelievable gross amount of 1.7 trillion Euro-dollars account for three quarters of the total credit of the Euro-market and commands virtually the same interest rates as U.S. dollars.

Meanwhile, our adversaries have far greater problems. They have given us a hard time but htey have a harder time of it by far. The Polish debt is unpayable; Rumania is hardly better; East Germany is facing its most severe economic distress; the Soviet Union is stripped of her hard currency -- hence the importance of the income from its Siberian gas. Less than a month ago, Castro found it necessary to warn the Cuban people in his annual ceremony reserved for heroics at the July 26th celebration of the revolution -- to warn that they were going to have difficulties in the coming years and the difficulties could be major. He blamed, of course, the capitalist crisis. He told his people they might have to face shorter work weeks and lower salaries. In a story bylined Ho Chi Minh city, a copy of the governmental report prepared by the IMF ws leaked in which the Fund expressed its doubt whether that country could possibly meet this year's schedule of payments on its external debt. Vietnamese reserves of foreign exchange, which were 98 million dollars at the end of 1980, were 16 million at the end of last year and, according to the report, completely exhausted by February. That what's known as "broke".

It is not quite clear who won in Lebanon. It is, however, clear that the Soviet Union lost. In primitive Afhanistan, the Soviet Union has been losing to the inadequately armed and almost totally disunited rebels, the force, brave and determined myahadeen. These rebels cannot drive the Soviets from their country -- but each month it is clearer that neither can the Soviets prevail. No more than martial law has suceeded in housebreaking Poland.

Regrettably the one area of success for Soviet orbjectives is the most important to them and to us -- disunion and growing distemper in the Western Alliance. The Finlandization of Western Europe has been the most constant purpose toward which the Kremlin has aimed since 1946.

The State of the Union -- ours at home is now truly unseperable from growing crisis within NATO, Zenophobia in Canada, anarchy in Central America and the most acute danger in Mexico in 50 years.

I have turned to others for appropriate words of wisdom to conclude this incomplete review of our present danger and opportunity. Winston Churchill offers some words of comfort, "If there is anything worse than going to war with allies -- it is going to war without them". Frederick the Great makes an observation singularly appropriate for the simple minded clamor for nuclear cercease, "Diplomacy without arms is like music without instruments". Alexander Haig pronounces a delphic conclusion which I leave to your interpretation, "There is a lack of definiti in the sina qua non area". But the ultimate caution comes ffffrom one of our neglected political philosophers Warren G. Hardy, "Don't drop the anchor til you are out of the woods".