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The Transition from Recovery to Expansion in 1984

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Never has such a strong economic recovery been so scrutinized for flaws and failures. Oil shocks, foreign entanglements, and overseas "sourcing" by consumer and business impel our search for risks to economic expansion. From almost all quarters of the financial world comes the plaintive cry, "Shouldn't there be something wrong?"

Our concerns have been heightened by contemporary failures in forecasting the business cycle. Economists underestimated in some cases the depth, and in most cases the duration of the 1979-1981 recession. The strength of the recovery in 1983 was a surprise. I am reminded of the deliberations of a conference of distinguished economists which took place in Washington just one year ago. The keynote address consisted of a logical and persuasive argument that high level inflation was here to stay because of flawed political processes and a monetary policy implemented in the absence of a simple, fixed rule.

How comfortable should forecasting's past failures make you feel about the current consensus of business economists that real growth in 1984 will be near 5 percent and that inflation will run between 5 percent and 6 percent? Serious efforts are being undertaken to address the difficulties of determining the effects of the new relationships endogenous to economic activity. Within the context of these difficulties, it is quite rational to voice continued concerns about the sustainability of economic growth and the possibility of a renaissance of yesterday's destructive inflation rates.

The economic process is in transition from recovery to expansion: business fixed investment expenditures will play an increasingly important role in generating real growth. However these expenditures must be made in the face of today's high cost of capital, both in the equity and credit markets.

High capital costs, in part, reflect a market environment in which the federal government's high spending, high taxing and mega-deficits constitute a terrible troika of impediments. We have an enormous rebuilding task before us in revitalizing both the industrial and the service capacity of our economy. As business expansion proceeds further, crowding out will occur through the displacement of capital credit demands by an increasing level of federal spending financed through the markets. Every deferral of plant, equipment, and research and development expenditures subtracts from future productivity and economic growth.

Capital investment has been relatively low for several years: short run capacity constraints in many industries might well be reached this year or next. Cost-push inflationary effects are increasingly probable in economic sectors that are at or, in some senses, beyond what has hitherto been regarded as "100 percent capacity." Recovery in 1983 was aided by the thrust of industry and the services trades to reequip and modernize in maintaining or achieving competitiveness. However, the next stage of substantial increases in "plant"—which may well be an office building for a consumer services firm—will be harder to come by in the face of aggressive competition for credit resources from the public sector.

Production and employment weakness in our export industries has been a major inhibiting factor in the recovery. Export expansion is weak in markets represented by the less-developed countries, as those countries struggle to service their debts, restructure their external accounts and finance their own economic recoveries. Export industries also are hamstrung by weaknesses in the currencies of our trading partners: sterling, the French franc, the cruzeiro, the peso, and even the Deutschmark at times. Unfortunately, when the major foreign currencies strengthen, perhaps suddenly, against the dollar, our export industries will benefit only after a lag. Meanwhile, financial markets may undergo, temporarily, wide fluctuations from any sudden major fall of the trade-weighted value of the dollar.

The present economic expansion is also vulnerable to the threat that expanding market demand and continued profitability may cause management and labor leadership to abandon the attitudes of cost containment, work rule flexibility and productivity which served us so well in 1982 and 1983. Our experience with high inflation, low growth and rising unemployment in the 1970s shows that we cannot promote business policies that result in continued loss of domestic market share to more efficient foreign competitors. It is not a problem that will be cured by erecting the barriers of protectionism--our economic health depends too heavily on the maintenance of open world markets.

The sustainability of an economic expansion is, of course, aided by the widespread recognition of these and other possible pitfalls. The private sector has utilized its cash flow in the initial expansion of equipment spending. In addition, we may be underestimating the productivity gains and the efficiency from changed attitudes derived from the experience of the long recession, particularly in the important services sector which now is our primary source of new employment. Those word processors, personal computers, and other communications equipment are beginning at long last to have a positive effect on productivity.

Price responses in this upturn may be different from those which have characterized the first years of previous postwar recoveries. In part, this is a function of foreign "sourcing" by a wide spectrum of firms including retailers--"the other side of the coin" regarding the weak cruzeiro or French franc.

Deregulation in transport, communication, and financial institutions has also had some positive effects in pricing responses. That is, the functioning of domestic markets is now toward inhibiting price increases and indirectly affecting the collective bargaining process.

A balanced view of our international trade and credit vulnerabilities admits 18 months of progress in coping with international debt exigencies. Extremely complex negotiations have taken place between governments, central banks, governmental agencies, international bodies and thousands of commercial banking operations all over the world. In addition, major debtor nations in the less-developed world have adjusted domestically--changing governments and altering policies--to cope with political tensions at home.

Today's global financial environment gives substantial promise that the major debtor countries may have at least gained the necessary time to adjust their policies and position their economies up on a plane of rising economic growth for the future. It is to be hoped that, after this multi-year workout period, markets and institutions will evaluate the potential of developing economies with increased realism, recognizing the limitations to their ability to absorb capital and economic change.

This is not to say that the accomplishments of refinancing international trade and credit, having worked for us in the past critical period, will provide a tried and true financial and development methodology that will forever suffice in complex world markets. Indeed I would argue that our limited success domestically and internationally has in truth given us merely a breathing space in which to consider new approaches to policy.

We must continue to develop additional tools for meeting the challenges. Thus it is encouraging that in current discussions of U.S. fiscal policy, creative approaches, such as providing a line item veto for the presidency (a proposal which would have been given short shrift even a year ago), are now being seriously considered.

In international matters, there have been constructive discussions regarding alternative financing tools, including the possibility of swaps of debt held against one country for another with some cash to boot. Another proposal of merit in this area is the idea of rolling over or originating foreign credits into part new credit and part equity.

An important portion of the LDC debt is in credit extended to private enterprises and to state-owned or partially-owned corporations. Like productive enterprises everywhere, the more successful and profitable of these organizations will continue to be good candidates for additional credit over time. I believe we should carefully examine suggestions from Allan Meltzer of the Carnegie-Mellon University and others that the rollover of some existing debt and even the evidences of indebtedness on new credit could be part new equity and part new debt. Such credits could bear lower interest rates than debt-only arrangements. Commercial banks in their international operations in a few countries such as Brazil already can hold equity positions. To the extent that this process fosters the establishment of secondary market values for the equities and possibly for debt instruments, its extension throughout the spectrum of LDC lending could have the salutary effect of attracting nonbank equity investors into the stronger LDC enterprises.

This experience, if favorable, would mitigate the difficult question as to whether the process could be constructively utilized in the rollover of existing debts. There are, of course, obvious accounting and regulatory difficulties to be overcome regarding this kind of restructuring and refinancing. It would seem only prudent banking policy that creditors avail themselves of the opportunity for divestiture of the equities acquired as a market developed for them. National pride is deeply involved in "giving up" equity or revenue participation attached to debt instruments. However, we face several difficult years in which governments and institutions will be dealing with these credit workout situations which will demand the consideration of creative solutions. The vital need of developing countries for growth after refinancing or restructuring demands our attention to worthy alternatives.

In collective bargaining situations, it may be that management has learned to involve labor more in locating new plants and expansion of existing ones as well as the considerations which go into the downward adjustments of their productive capacity. Union leadership in industries under the pressure of very low capacity or deregulation have gone beyond concessions in wages and benefits and agreed to changes in work rules and other prerogatives lying outside compensation.

I believe that monetary policy has contributed to the reduction of inflation and even of inflationary expectations to some degree. In this regard, monetary policy has contributed importantly to the economic recovery and is designed to make a similar positive impact upon today's economic expansion. I cannot tell you that it has been possible to implement the advice of last year's Monetary

Policy Conference to seek a simple rule to guide policy. But policymakers are aware of the new financial instruments and new behavior of old instruments that have characterized the past few quarters, and their impact is being taken into account.

In 1984, the Federal Reserve will work with commercial banks in a transition to a system of contemporaneous reserve requirements and will pursue additional efforts regarding the effective communication of developments in the monetary and credit aggregates. In all of this, it is our hope to increase the knowledge and awareness of money managers in the banks, other financial institutions, and financial markets at large as to the directions and goals for monetary policy.

In short, the answer to the question "Shouldn't there be something wrong?" is "Not so likely this time."

There are great avenues of opportunity before us to be built upon the foundation of our progress against inflation and toward increasing the productive capacity of our nation. The problems facing us are recognized and can be effectively addressed. What it will take, however, is a continuation of the cooperative efforts between the financial community, private sector, labor, and the economic policymakers to foster and promote a concrete transition to economic strength and expansion.