Sustaining the Business Expansion

By PAUL A. VOLCKER
President, Federal Reserve Bank of New York

Remarks before the Conference Board's Conference on Management of Funds in New York City on Wednesday, May 19, 1976

I am delighted to address this Conference Board session. Those of us who spend our working day concerned with monetary policy obviously share a broad area of interest with those engaged in the daily management of financial funds. We have together passed through troubled times in the 1970's. Yet, I also suspect that, looking back from our different perspectives, most of us can also share a feeling that more recent economic developments have been at least as favorable as we could have dared hope a year ago.

Indeed, it is already hard to recapture the atmosphere of gloom prevailing in the opening months of 1975. To be sure, by last spring, there were signs that the precipitous decline in production might be ending. A rebound in stock prices seemed to suggest that forebodings that the worst of our postwar recessions might turn into genuine depression were receding. But prospects for vigorous recovery were still sharply questioned.

The outlook for financial markets appeared to many to mirror a wider economic dilemma. Despite high unemployment and unused capacity, inflation remained high. If recovery was brisk, what little progress had been made on inflation would be jeopardized and, with it, prospects for sustaining growth. The need for economic stimulus seemed to justify tax cuts and historically large deficits. But the effects of those deficits on financial markets, already sensitized to inflation, were widely feared. In the face of the deficit, there were doubts the Federal Reserve could or would adhere to its expressed intention to keep the monetary aggregates growing at a moderate pace. In these circumstances, the prospects for interest rates seemed less than propitious. Moreover, a near crisis developed in municipal finance, growing out of the deep-seated troubles of New York City. And attention focused on the banking system, as it coped with the largest loan losses of the postwar period, brought new financial uncertainties.

Yet through it all, the economy in fact performed remarkably well. During the past four quarters, output has expanded by some 7 percent, about equal to the average for the first four quarters of earlier postwar recoveries. Unemployment, while still far too high, has declined significantly, and employment has reached new highs. Significantly, all this has been accomplished while the rate of price increase has declined—only modestly and unevenly but nonetheless in the right direction. A renewed rise in productivity, after a long period of stagnation, assisted that process. Profits have certainly improved. Interest rates, after declining during the recession, have not risen at all a year after recovery began. Some progress has been made toward strengthening the liquidity and capital position of financial and nonfinancial businesses alike, and monetary growth did remain within intended ranges.

What should we make of this experience? Were the concerns expressed a year ago merely premature, or have we indeed turned the corner in bringing the economy under better control? Can we now look forward to sustained expansion?

Quite obviously, only time can provide a full answer to those questions. But they still seem to me worth posing, for the answers will not be independent of the actions we have taken, and must yet take.

We can see now that the severity of the recession of 1974 and 1975 was a reaction not to any one dramatic event, but to a whole series of interrelated developments and attitudes arising over a long period of years of rela-

tive prosperity—attitudes and developments that ultimately could not be sustained. These developments grew in part out of widely held views that, by the 1960's, we had identified ways and means of assuring that serious business downturns were a thing of the past. The conviction spread that, in the last analysis, prosperity could be maintained at the expense of inflation—certainly an evil, but a lesser one.

For a time, events seemed to bear out these views. But, beneath the surface, it was these same attitudes that contributed to economic behavior and trends that, sooner or later, spelled trouble. For instance, as people confidently began anticipating sizable increases in real income year after year, there was a tendency to reach out for more than the economy could in the aggregate provide. The result was not more real income, but inflationary pressure. And, when the large increases in oil and food prices suddenly reduced the real income of the mass of urban workers, the shock could not be absorbed without sharply accelerating the inflationary process.

Meanwhile, there had been a tendency to downgrade the inevitable risks of economic life and to relax accepted rules of economic prudence. In this atmosphere, liquidity and balance-sheet ratios of both financial and nonfinancial institutions were permitted to erode. The process was seldom viewed with alarm; instead, for a time the stock market seemed to reward high leverage and reduced liquidity as measures of financial efficiency and as signals of alert management.

Then, as inflation speeded up under the weight of a worldwide boom and the oil crisis, expectations of inflation began to permeate financial markets and business decision making, and the dangers suddenly became more apparent. A financial squeeze developed, and interest rates reached new highs. As the boom slowed, confidence in the outlook was rapidly dissipated, and financial dislocations aggravated the recession.

It is easy to see, in retrospect, that the seeds of the recession were laid much earlier. But the timing is never obvious. Indeed, the timing and severity of the recession were clearly related to the unpredictable shock of the oil crisis. Given the heavy impact of that and other special factors aggravating the vulnerabilities in the world economy, there is a sense in which we can count ourselves both fortunate and wise in the manner in which we handled the recent recession. Internally, there was a significant risk of contraction feeding upon itself; externally, nations could have been tempted into aggressive, beggar-my-neighbor policies.

Those risks remained just that—risks and not realities. Broadly appropriate monetary and fiscal policies, and a widespread grasp of the ultimate futility of seeking prosperity at the expense of other nations, deserve much of the credit. Given some of our past history, when long periods of boom ended in prolonged depression, I think we can fairly say we have learned something.

But have we learned enough—not just how to deal with severe recession but how to maintain a balanced expansion, an expansion that could proceed for some time?

I can see some hopeful signs—signs of a shift of attitudes that are partly intangible and admittedly hard to measure but are no less important for that reason. Perhaps ultimately most important, the wide belief that we could maintain prosperity by accepting inflation has rightly been shaken. The evident strains and difficulties of recent years seem to be producing a healthy new respect for economic risk and for the economic limits on what we can achieve.

For evidence, I would point to diverse areas. There are new worries over the size of the Federal budget and over the tendency for deficits to expand beyond plans and expectations, a concern reflected in the new procedures for Congressional decision making on the budget. State and local budgeting practices are being tightened. Both financial and nonfinancial businesses are placing more priority on building capital and balance-sheet strength.

But I must also say the evidence is still ambiguous. As the economy recovers, the old patterns of thought could return. More specifically, in the face of the highest unemployment since the Great Depression, the rise in wage rates in important sectors of the economy marked by large collective bargaining agreements appears to have slowed very little, if at all. Of course, the desire to restore lost purchasing power is readily understandable, as is the eagerness of many businesses to protect and increase profit margins. But understandable as those motivations are, in perpetuating the inflationary process they hamper the growth that in the end can be the only source of real increases in wages and profits.

Obviously, I do not draw from what has happened a pessimistic and fatalistic view that we cannot contain inflation and sustain the recovery. But I am afraid there is nothing inevitable about such a happy outcome. Much will depend upon the choices we make from here on out in a number of important areas, and I want to spell out some of the considerations bearing on these choices.

I have already said enough to suggest that, to my mind, the first and foremost condition for sustaining economic expansion is avoiding a resurgence of upward price and cost pressures. The notion that price stability and economic prosperity are competing goals over any substantial

period of time—an idea inferred from, and given apparent scientific sanction by, the so-called Phillips Curve—seems to me the most pernicious fallacy generated by economic thinking in the postwar period. I don't want to claim that the theories of economists—defunct or otherwise—control all our decision making; we don't need to look to economic theory to be concerned about a bias in political processes toward spending rather than taxation, and toward more money rather than less. But there can be little doubt that the assumption that a little inflation can be traded off against more jobs has influenced macroeconomic demand management at critical junctures. For a period, the trade off seemed to have worked. But the game was up when it came out in the open, and when the implications were widely understood.

Today, markets have a way of anticipating, and reacting to, the price implications of expansionary actions almost as soon as—in some cases even before—those actions can be effectively implemented and affect real economic activity. As money markets and markets for wages, goods, and services react to expectations of inflation, higher prices and interest rates tend to offset the stimulus sought.

As a result, the econometric work that seemed so persuasive earlier in the postwar period no longer fits the facts. In technical terms, the Phillips Curve has become highly unstable. And the recent work of economists has gone a long way toward undermining its theoretical rationale.

I don't know how deeply that lesson has yet sunk in among economic decision makers and commentators generally. But I do think it has already had a strong impact on national policy, for the danger to continuing expansion from a fresh acceleration of inflation, in present circumstances, has become readily apparent.

Rising costs of inventory and plant and equipment directly increase borrowing needs at a time when neither retained earnings nor balance-sheet ratios are as strong as they have been during most of the postwar period. Financial institutions, now in the process of rebuilding their financial strength after the erosion of earlier years, are not in a position to support readily the increase in assets and liabilities that would be generated by a combination of rising activity and accelerating inflation. Governmental bodies—particularly on the state and local level—would be exposed to intense financial pressures, and would need to review spending plans anew. The credit markets would move to anticipate the pressures, and interest rates would rise. And on past patterns the consumer, who has been providing the main driving force for expansion, would likely pull back in an attempt to conserve his financial position.

Now, the simple fact is that—at least through the first quarter of this year—price performance did not deteriorate in the face of recovery; indeed, it has been unexpectedly good. I suspect that single fact helps account for much of the rebuilding of consumer and business confidence that we are seeing. It goes a long way toward explaining the relative stability in interest rates.

In appraising this record, I think we need to recognize there are also strong grounds for believing that the exceptionally good price performance of the early months of this year was simply too good to last. The relatively small advances in the major price indices during the first quarter —summarized in the rise of the GNP deflator at an annual rate of less than 4 percent—were made possible by actual declines in prices of fuel and food. I have no special crystal ball to permit me to foresee the consequences of the next OPEC meeting, or the balance of supply and demand in agricultural markets, but I do have a skepticism that we can count on quite such favorable trends continuing. In other areas, we do know the recent price picture has been less impressive. For instance, consumer prices, apart from food and fuel, have been increasing at an annual rate of 8 percent this year.

Moreover, there have been a number of indications suggesting that, in areas particularly sensitive to cyclical influence, the price picture might actually be deteriorating somewhat. Thus, prices of raw industrial commodities have begun to move up again this year, recovering a significant part of their recession decline. Industrial buyers are now reporting a striking rise in the proportion of sellers quoting higher prices; those reporting price reductions have declined to negligible proportions.

I don't know how far these signs of renewed pressure on sensitive industrial materials prices will go, or how long they will last. But, in and of itself, the stirring is not necessarily surprising or alarming, considering that we have had a full year of recovery from abnormally depressed demand conditions in commodity markets.

The trouble is, of course, that we cannot consider these more cyclical elements in isolation. The firming of sensitive prices is superimposed on a more basic, underlying upward trend in the price level. I do not find it at all comforting to think that we may be coming out of the worst postwar recession with what I would term the "base rate" of inflation running at perhaps 6 percent a year or even a little more. By base rate, I mean that rate of inflation that appears to be implied by recent trends in wages and other continuing cost elements, after allowing for normal productivity growth.

The striking improvement in recorded price trends since the peak rates of 1974—when we saw increases of

12 percent for consumer prices and 25 to 30 percent for industrial wholesale prices—reflects in substantial part the removal of a host of special factors that were then operating to push prices sharply higher: the crop shortfall, the rise in oil prices, the effects on the internal price level caused by the depreciation of the dollar, and perhaps some "catch-up" effects after the ending of wage and price controls.

In that earlier period, those more or less special factors, in combination with strong worldwide demand pressures pressing on capacity, could be held responsible for inflation. Wage rates lagged, and so did the real income of most workers. Indeed, in real terms, the wages of the average urban worker sooner or later had to decline in the face of sharply higher prices of food, fuel, other materials, and imported goods.

Now the situation is quite different. The special factors have subsided. Capacity is ample for present demand. Productivity is growing again and, with it, the opportunity for renewed growth in real wages, as well as profits. But aggressive efforts to recover past losses in real income, as they affect costs, threaten to prolong a substantial rate of price increase, even before allowance for more cyclical factors.

I am not suggesting that we face any imminent threat of repeating the extreme price developments of 1973 and 1974—not unless the extraordinary external forces of that period were to be repeated, or the monetary and fiscal authorities were to lose all sense of prudence. What I am suggesting is that prospects for maintaining the business advance—an advance that today has considerable momentum—through 1977 and beyond is critically dependent on our ability to nourish and sustain the returning confidence. That, in turn, rests on our ability to come to grips with the stubborn forces that underlie the continuing inflation.

I cannot set down a scenario for public policy that will *guarantee* success in that effort. Indeed, success or failure will turn on private attitudes and policies as well as on the large decisions of monetary and fiscal policy. Nevertheless, some broad elements in a successful strategy for public policy—and particularly monetary policy—seem to me reasonably clear.

In approaching that issue, it is worth emphasizing some questions surrounding private investment activity—an area often considered particularly sensitive to monetary policy. That is also an area which, not atypically, lagged substantially in the early stages of recovery. In real terms, activity in a few industries appears to have picked up since late 1975, but many businesses still appear hesitant in undertaking new commitments.

Any prolonged sluggishness of investment activity, following the decline during the recession, would seem to me unfortunate, not just in terms of the longer term potential for growth, but in terms of the prospects for maintaining a solid recovery over the next few years. It was not so long ago—in 1973 and 1974—when we experienced rather widespread shortages, even while unemployment was still at unsatisfactory levels. Since then, we have of course added some capacity, and only now is real activity reaching earlier peaks. As a result, we appear to have some leeway for expansion. A similar situation prevails in other industrialized countries.

Nevertheless, in shaping our policies, we must be concerned not only with the situation today, but with what could develop in 1977 and 1978, for the lead times on investment are long, and there are lags in responses to policy actions. Specifically, we need to appraise the danger that some important sectors of the economy might again press against the limits of productive capacity well before the available work force can be fully absorbed. The result could be to produce price pressures that might be loosely classified as "demand pull", even when, in a broader perspective, the economy is still operating at clearly unsatisfactory levels of employment and with excess capacity in other lines of activity.

Now, I would quickly admit that judgments in this area are difficult. I do not find notions of "potential GNP", essentially based on trend line calculations of the productive potential of our labor force, very helpful in this context. The changing composition of the work force over the past decade—with more inexperienced teenagers and women in the job market—has itself raised questions about some of the older rules of thumb. More important in the immediate situation, those calculations do not purport to take account of plant capacity.

There are, of course, some statistical calculations of the current relationships between capacity and output. But they are not fully enlightening, for they do not agree. In the first quarter of this year, the various widely cited measures of industrial-capacity utilization ranged from about 72 percent to about 84 percent. And the various series show quite different movements over time, from the peak to trough of the business cycle, and from the past through to the present, casting further doubt on their reliability. Apart from the uncertainty in these calculations for manufacturing as a whole, we know that capacity in one industry (or in one part of an industry) often cannot be substituted in another. With the structure of demand always shifting, bottlenecks can develop in particular areas well before aggregate measures of capacity utilization suggest strains should appear. Amid these statistical and

conceptual uncertainties, we can hardly be oblivious to the warnings of some businessmen who have foreseen capacity pressures in particular industries developing next year, assuming demand continues to grow.

The fact that investment activity has been relatively slow to participate in the expansion is perhaps not surprising in the light of the severity of the recession, the relatively poor profit performance of American industry over a period of years, and the strains on financial positions. Nevertheless, the early *pattern* of expansion—with consumption so relatively strong and investment so relatively weak—had disturbing implications for our longer run ability to deal with inflation and to sustain the expansion. Indeed, the environmental requirements that face business today mean that a larger proportion of the capital spending that is taking place may be less effective—per dollar spent—in adding to capacity or efficiency than in the past.

We can see in this immediate situation a reflection of some of the concerns that have been expressed about a growing "capital shortage" in the United States. In a long perspective, I confess I find that concept somewhat elusive. Much of the concern has been focused on the possibility of a shortfall in aggregate savings. My own inclination is to view the problem more from the other side of the equation—have we, largely inadvertently, impaired *incentives* for capital formation so that we don't use with maximum effectiveness savings that can be generated?

In that connection, I believe we could usefully direct much more attention to our methods of taxation, and particularly the way we tax corporate profits in this country. In particular, it seems to me ironic that this nation—rightfully viewed as a bastion of the free enterprise system—has been among the slowest of the industrialized nations to achieve some integration of the personal and corporate income taxes, thus ending or alleviating the present practice of taxing the return on equity capital twice.

But tax reform is not a speedy process. Nor can we prudently attack the investment problem by simply pumping more money into the market in amounts substantially in excess of longer range needs.

I have already alluded to the relative stability of interest rates through the first year of recovery. This period has also seen major increases in some of the broader measures of liquid assets. These developments have been reflected in some improvement in the liquidity of financial institutions, have facilitated considerable funding of short-term debt assumed earlier by businesses, and have thus promoted a more favorable climate for capital spending and for economic expansion generally. With the cyclical improvement in profits and the broad increase in demand providing stronger motivation for investment, the clear signs of stirring activity in that area are not surprising, and they are welcome.

But there are clearly limits to the extent that that process can be promoted by the expansion of money and credit. That process would be self-defeating if prudent limits are exceeded, reawakening inflationary fears and pressures and eventually provoking increased interest rates, rather than holding them down. I would remind you, too, of the long time period from investment *decision* to investment *in place;* the favorable consequences of plant and equipment spending for capacity lag substantially the consequences for demand.

I can wish we had more capacity in place sooner, thus providing a greater measure of protection against demand pressures down the road. But policy needs to be based on realities and probabilities, not wishes. In these circumstances, wisdom dictates the need for maintaining, through the monetary and fiscal tools at our disposal, a climate for moderate growth in demand. The alternative of a quick dash for "full employment" at the expense of renewed inflation would jeopardize the chances for *sustaining* expansion over a lengthy period, and for maintaining a healthy climate for investment as well.

It is this approach that has characterized, and continues to characterize, monetary policy. I do not want to wade into a lengthy discussion of all the technical aspects of targets for monetary aggregates—just how they should be set, how important they should be regarded relative to other considerations, or just what their numerical values should be. But I do think that the broad strategy embodied in those targets should be clear.

In publicly announcing a range for the various monetary indicators, the Federal Reserve has attempted to underline clearly two points. One is that there are upper bounds to the amount of monetary expansion that can be set without risking—and promoting—a resurgence of inflationary pressure. At the same time, the targets have been set at a level that recognizes that the strong inflationary momentum that has developed over a period of years cannot be squeezed out of the economy abruptly, without damage to the recovery process. Consequently, the targets have been set above levels that, in the near term, are consistent with price stability.

The corollary of this approach is that over time restoration of price stability will require a gradual reduction in the average rate of money growth from recent experience and current targets. As a step in that direction, Chairman Burns announced earlier this month a slight reduction in the upper ends of the range of some of our longer term monetary-growth targets. These small reductions also reflect the fact that the economy has been showing a very

satisfactory recovery without overly rapid growth in M_1 or M_2; indeed, the growth in M_1 has been quite modest over most of the past year.

I suspect that many of you are in as good a position as I to judge whether we can adhere to these targets without a pronounced rise in interest rates. Over time, that will depend on such factors as the rapidity of economic growth, the strength of wage and other cost pressures, and progress in reducing the budgetary deficit. I would note, in that connection, that the widespread forebodings a year ago were not borne out; interest rates at times did rise for awhile, but the rises were subsequently reversed. I recognize that the fact that interest rates changed very little on balance over the first full year of recovery was unusual in the light of past experience. We cannot count on such a pattern continuing indefinitely—nor would some cyclical rise in short-term interest rates be disturbing. In a context of orderly advance and diminishing inflation expectations, such cyclical increases in money market rates need not have a pronounced effect on long-term rates.

My greater concern by far would be a situation in which interest rates moved higher in response to a renewed burst of inflation, both through its effects on the demands for credit and on expectations. Over time, prospects for lower interest rates remain inextricably tied to prospects for squeezing out the inflation premium still built into the existing rate structure.

The speed with which we can achieve that happy result will depend, in my judgment, as much upon the prudence and responsibility of private conduct as on monetary and fiscal policy. Those instruments can create a certain climate and financial environment indispensable to success. But they will not reconcile the need to work toward stability as we sustain expansion if more or less autonomous cost pressures are strong. In particular, there are some conspicuous wage negotiations and pricing decisions in our economy that, at least in the short run, are by no means rigidly determined by prevailing economic and financial conditions, and whose very size and visibility make them something of an independent force on the cost structure of the economy. In the past year or more, some signs have developed that, while the rise in money wages has slowed to some extent—as it must if costs and prices are to level out—that trend has been strongly resisted in more heavily organized sectors of industry. It is not likely that those patterns will diverge for long—but much is at stake in how the gap is closed.

In the end, *real* wages and *real* profits can increase only out of productivity gains for the economy as a whole—and all experience shows those gains are likely to be greatest during a period of sustained, orderly business expansion. To the extent wage and other cost pressures—passed quickly into the price structure—jeopardize that prospect, they hardly serve the interest of labor or business as a whole, whatever the short-run advantage may appear to be.

In sum, there is much that is happening that supports confidence in the future. The harsh lessons of the 1970's have put into motion needed changes in attitudes and practice. Those changes are reflected in both private practices and public policies.

But the returns are not all in. The lessons can be forgotten in the flush of returning prosperity. The rate of price increases remains unacceptably high—and the expansion that is proceeding so nicely now remains vulnerable to a resurgence of inflationary expectations.

The risk is not simply, or only, that we would lapse into another recession before we have fully restored prosperity, painful as that would be. In those circumstances, strong voices from many sides would, with some apparent justice, press for far-reaching changes in the way we manage and control our economy. And I suspect we could find ourselves heavily pressed to sort out constructive change from changes that, in fundamental ways, would damage the market system that is so much a part of our political, as well as economic, heritage.

Much hangs in the balance as we appraise the prospects for sustaining the expansion that seems so promising now. The particular financial issues and questions you are exploring today are a big element in the broader prospects. Monetary policy, in particular, can be effective only as it works through the market process. As we move ahead, we will need the benefit of your understanding and your judgments in shaping that policy, just as I hope you will understand our own intentions and share our purposes.