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MAINTAINING THE EXPANSION BEYOND 1985

Remarks by

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before

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To some, it might seem anomalous for a member of the Federal Reserve Board to be focusing on the prospects for the economy more than a year in the future. A reading of the business press would suggest that the context of policy making at the Federal Reserve is the day-to-day wiggles in financial markets, the weekly M1 numbers, and the monthly economic indicators. And, to be sure, we do spend a good deal of time scrutinizing those signals carefully. But we also recognize that our ability to fine tune the short-run movements in the economy is extremely limited. Our mission as central bankers relates more meaningfully to longer-term trends and to the stability of the system.

I shall not ignore the short run in my remarks today, but my emphasis will indeed be on the longer run and, in particular, on the tasks facing us if we are to set the stage for the kind of economic performance we'd all like to see in the latter half of the 1980s. In identifying those tasks, however, an assessment of the current state of the economy will provide a most useful starting point.

The Economic Recovery

Two years have now passed since the economy reached the trough of its worst economic slump since the Great Depression. The economy has recorded many striking achievements over the course of the current expansion--achievements that are perhaps all the more striking when one recalls how gloomily most forecasters viewed the prospects for recovery in the closing days of 1982. Measured by growth in real gross national product, this has been the most robust upturn since the boom that followed the Korean War. The number of people employed has climbed more than 7 million, reducing the unemployment rate by more than 3 percentage points--and bringing many of those laid off during the recession back onto payrolls.

As a group, Americans have enjoyed the first real gains in their living standards in some time, owing in large measure to renewed growth in labor productivity. In good part, the improvement in output per hour worked has been the normal cyclical result of mobilizing resources that were underutilized at lower production levels, but it has also reflected the payoff of investment in new technology and an awakening by both labor and management to the fact that actions to enhance the efficiency of American industry were imperative.

Perhaps the most striking development--and the one constituting the biggest turnaround from the trends of the preceding decade--is that this strong recovery has been accomplished without any hint of a pickup in inflation. Price inflation appears to be running currently at roughly a third of the peak rates of 1979-81, with no acceleration thus far as the expansion has progressed. Obviously, there is still a substantial amount of slack in the economy and this has been a big factor restraining wage and price increases. But a number of other influences, including the better productivity performance I just noted, have contributed to the containment of inflation. The strength of the dollar, favorable developments in the world oil market, and a widespread sense that monetary policy is firmly committed to the attainment of reasonable price stability have all contributed to the disinflationary process.

Looking at the major expenditure components of GNP, the rising economic tide clearly has lifted many boats. Strong increases in disposable income and high levels of consumer confidence, coupled with a large backlog of demand robust spending for automobiles and other big-ticket items. The rebound in outlays for new housing has exceeded gains during most previous recoveries. Here, too, pent-up demand undoubtedly has played a role--rooted in favorable demographic trends, as the so-called "Baby Boom" generation has moved into peak family formation years. The housing sector has benefited as well from relatively stable house prices and innovations in mortgage finance that have helped to blunt the effect of still-high interest rates.

In the business sector, sales and profits have risen markedly, prompting vigorous spending for new plant and equipment. Sophisticated electronic production and information processing equipment led the way, along with motor vehicles, but heavier equipment and construction spending subsequently joined the surge. Meanwhile, business have tried to keep their inventories lean relative to sales, in order to avoid not only hefty carrying costs but also the risks of excess stocks in the event of sales disappointments.

The Recent Slowdown ... and Near-Term Projects

Recently, of course, economic expansion has slowed. Some slowing from the pace earlier in the economic upswing was inevitable, but the sharpness of the deceleration has prompted fears in some quarters of another recession--or at least of a prolonged period of sluggishness and rising unemployment. I think that it is important that we not lose sight of the positive elements in the picture; viewed in its totality, the evidence to date provides little basis for thinking that we are experiencing anything more than a temporary lull as the economy moves onto a sustainable growth trajectory.

The recent slowdown in sales evidently was sharper than many businesses had anticipated, and was intensified for some firms by growing competition from imported goods. Businesses have moved quickly to control inventories, and this has been reflected in orders and production over the past few months. But these timely adjustments--and the earlier caution in stocking--should keep the pause a short one, and could pave the way for a marked resurgence once the favorable trends in domestic final demand reassert themselves.

And I believe they will. In some cases they are already apparent. In the automobile industry, for example, demand remains fundamentally strong; production has been inhibited by strikes and other transitory supply problems, and the very leanness of auto dealers' inventories has been a major factor depressing sales in the past few months. Looking at the consumer sector more broadly, sentiment has remained favorable and growth in spendable income has been well maintained despite the slowing economy.

In the business sector, capital goods orders have been weak of late at domestic manufacturers, but perhaps reflecting the growing importance of imported equipment, surveys suggest that overall plant and equipment spending plans for the coming year remain healthy.

And we can not overlook the fact that interest rates have come down appreciably since the summer. With the customary lags, we can expect the easing of rates to buoy spending in housing, consumer durables, and other areas during the months ahead.

In short, I believe that there are good reasons for optimism about the near-term prospects of the economy.

Imbalance and Stresses

Looking further into the future, however, we need to recognize that, for all the gains the recovery has wrought, the economy today is characterized by some important structural imbalances and financial strains, which cast something of a dark cloud over the economic horizon. These problems really have come into clearer focus since we moved beyond the more exuberent early phase of cyclical rebound. While I don't want to suggest that these problem areas represent a clear and present danger to the economic expansion in the period immediately ahead, I do want to emphasize that a failure to recognize and address them would appreciably reduce our chances of achieving a healthy, balanced, smooth expansion over the longer run.

One very disturbing aspect of the economy today is the fact that there are significant sectors that have not experienced anything approaching renewed prosperity. For example, some of our basic industries, such as steel and heavy machinery, still are operating at low levels and many companies in those industries are fighting for their very survival. In agriculture, income remains depressed and many farmers--particularly those who incurred heavy debts during the earlier boom years--are being severely squeezed by high rates and falling land prices. Certainly, we know that in a dynamic economy some sectors will rise in importance over time and others will fade as a consequence of changing patterns of demand and changing competitive relationships internationally. But that does not mean we can ignore difficulties of the sorts we have seen, which have tremendous costs for the individuals affected and for their communities. Labor and management in the lagging industries must look realistically at the practices that have led to poor quality of output or that have tended to raise production costs, and take remedial action. But, we must also make sure that we are not stacking the deck against these industries through inappropriate macro policies.

It is important to note, in this regard, that the difficulties of some of our depressed industries are a part of a broader and very serious imbalance--namely, the imbalance in our trade with the rest of the world. Over the past couple of years we have seen our trade deficit skyrocket, and while a number of forces have been involved, the soaring value of the U.S. dollar on exchange markets has played a major role. The strength of the dollar, of course, has been beneficial to consumers and to many producers by lowering prices of imported goods and materials and by exerting competitive pressure on prices of domestically produced goods. But the other side of this coin is the difficulty faced even by many relatively efficient U.S. firms as they seek to maintain their sales in foreign markets or here at home. One very dangerous consequence of the deteriorating trade performance of U.S. industry is the increased clamor for protectionist measures that would be terribly harmful in the long run to our economy and to the economies of other nations.

Why has the dollar been so strong? That is a question to which no one has yet put forth a totally satisfactory answer. But I think there is fairly broad acceptance that our high interest rates have been a major factor. They have pulled capital in from abroad, and it's a matter of simple accounting that if there is to be such a movement in the net flow of capital, there must be a comparable but opposite movement in our trade balance. And to stimulate that change in the trade balance, the dollar must rise to discourage U.S. exports and encourage U.S. imports.

The third area of concern I want to mention is in the financial sphere. The stresses in the financial system have become quite evident. A number of banks, including some of the nation's largest, have experienced serious deterioration in the quality of their loan portfolios. In many cases such problems have been associated with overly aggressive lending policies pursued in previous years, often founded on a belief that rapid inflation would be a permanent feature of the economic landscape. Thrift institutions have continued to suffer severely constrained earnings because the yields from old, long-term fixed-rate loans don't adequately cover the costs of their shorter maturity liabilities. The debt servicing problems of many developing countries in Latin America and elsewhere have been acute, and have been exacerbated by high interest rates and the strength of the dollar.

I don't intend to address these problems of the domestic and international financial systems in much detail today. I do want to stress that, while an environment of generally lower interest rates would ease the situation considerably, it would certainly not solve all problems in financial markets. Orderly and full resolution of the debt service problems of the developing countries will require a strong cooperative effort by borrowers and lenders alike over a considerable period of time. Success will depend greatly on the efforts of the individual countries to reorder their finances and clear away the obstacles to efficient resource allocation and long-term real growth. Domestically, banks and thrifts with heavy loan exposure in troubled sectors of the economy remain vulnerable in various degrees to liquidity and solvency problems. In the short run, the close attention of supervisory authorities to this situation and a readiness to deal appropriately with any problems of individual institutions continues to be crucial. Over the longer run, we need to see to it that our financial intermediaries are adequately capitalized to deal with the risks they have taken on and that our deposit insurance and regulatory systems provide the right incentives and constraints to avoid systemic instabilities.

In reviewing these specific industrial and financial trouble spots, it becomes clear that high interest rates and the high value of the dollar have been elements underlying each. This association, of course, causes the spotlight to be directed upon monetary policy. Some prominent critics of the Federal Reserve have asserted that we have been much too tight since mid-year. It is true that policy has continued to be aimed toward growth in money and credit that is consistent with lasting price stability. But, this goal need not be inconsistent with satisfactory growth, and we have been alert to the recent economic slowdown. As activity has weakened and demands for money have softened, the Federal Reserve has accommodated tendencies towards lower interest rates--most recently by cutting our discount rate.

The problems that I've described would not be alleviated over any meaningful time period by attempts to drive interest rates down by unrestrained money creation; relief would be short-lived at best, as heightened inflationary expectations and greater actual inflation would be reflected in irresistible pressures on interest rates. Moreover, should market participants perceive--rightly or wrongly--any shift in policy or economic circumstances that would make the growing proportion of dollar assets in portfolios less attractive, the dollar could drop precipitously, with potentially disruptive effects on financial markets.

What we need is a set of policies that eases the upward pressures on interest rates and the dollar without inflationary consequences. Fortunately, this does not really constitute a dilemma--at least not at the conceptual level.

The Key Imbalance

This becomes clear as soon as we recognize that high interest rates and the high value of the dollar are not purely monetary problems, but are partly a byproduct of another glaring imbalance in the economy--namely, the huge federal budget deficit. Redressing the structural imbalance between federal receipts and expenditures is essential if we are to deal effectively with the stresses in our economy and set the stage for balanced, sustained growth. The linkage between interest rates, the dollar, and the federal deficit is quite straightforward. Heavy federal demands for credit, in competition with strong private demands, have kept interest rates high. Though nominally much lower than at their 1980 peaks, interest rates are still exceptionally high in view of the much reduced pace of inflation currently. And, as I noted earlier, high "real" interest rates, in turn, have helped attract massive inflows of capital, pushing the dollar up sharply.

That the overall economy has prospered in the face of large federal budget deficits provides scant grounds for complacency. Administration projections in recent weeks have shifted toward even larger deficits in the future if no steps are taken to counteract that trend, and it is not clear that the economy can tolerate much further expansion of the deficit without breaking down in important respects.

To remedy the deficit problem will not be easy, but prompt movement toward this goal is crucial. Delay means that the problem only gets bigger, as federal debt piles up and interest payments grow even larger. Heavier taxation is not an especially attractive approach. Extracting larger revenues from taxpayers is not a popular idea, as the recent presidential campaign has made clear. It is, moreover, an idea of limited economic appeal as well, since raising tax rates would work against efficient resource allocation and thereby hamper economic growth. This suggests that ultimately the issues of tax revenue enhancement and tax restructuring can not--or at least should not --be viewed as separate.

Curtailment of federal spending likewise becomes a difficult matter when specific measures are contemplated. Various proposals for sizable spending cuts are being discussed, but in so many cases the existence of a politically influential constituency opposed to a particular piece of a plan stands in the path to significant reductions. I certainly believe that areas for judicious restraint in spending can be identified, and I am encouraged by the widespread awareness in Congress of the need to control the deficit. To do so, an ideological truce within the Congress and Administration will be necessary to cut back the least effective and least essential programs.

Long-Range Growth Prospects

The long-range economic outlook poses questions concerning both the sustainability of the expansion and its strength. As I suggested earlier, there is little reason to fear interruption of expansion in the near term, given the still solid underpinnings of demand in a number of sectors and the easing of credit market conditions that has occurred. Looking at the longer term, decisive action to deal with the imbalances and stresses in the economy that I've discussed is critical to provide reasonable assurance of sustaining economic expansion. The strength of economic expansion beyond 1985--as cyclical slack is taken up--will depend upon longer-run forces underlying the capacity for economic growth. A crucial determinant of growth beyond 1985 will be the efficiency with which the economy utilizes its resources.

Between the cyclical peaks of 1973 and 1981, real output per hour of labor increased at less than one percent annually, after growing at a 3 percent average during the preceding 25 years. Output per hour in the nonfarm business sector has increased at about 3-1/3 percent annual rate thus far in this expansion--and a continuation of productivity growth in that ballpark could permit economic growth to reach perhaps the 4 to 5 percent range.

Although the gains in labor productivity in the past couple of years have had a large cyclical component, I believe there are good reasons to think that an improved secular trend in productivity may be achievable in the years ahead. First of all, the recent strength in business spending has established a firm foundation for productivity growth. Significant additions to the capital stock have been recorded, and the increased proportion of equipment of recent vintage in that stock also helps to increase productivity. Continued strong capital investment in the future can reinforce and extend this improvement through the latter part of the decade. But we are not likely to see that level of investment unless we curb the federal government's huge appetite for our nation's limited savings.

Certain demographic trends are also favorable to sustained improvement in productivity. An increase in the proportion of young and inexperienced workers in the labor force contributed to the slowdown in productivity during the 1970s, but that trend is reversing in the 1980s. In this decade, the baby boom generation is entering the prime working ages, which will help to boost productivity. The average education and training of workers is also rising in general.

Technological progress, or its lack, is a fundamental determinant of productivity. Here, developments also are encouraging. Since the late

1970s there has been a pickup in outlays on research and development, a trend that was reinforced by the 25 percent incremental R&D tax credit enacted in 1981. Heavy spending on information processing and other "high tech" equipment bodes well for rising productivity. This may be particularly true in some of the service industries, where employment growth has been centered in recent years.

An important, though hard to quantify, factor boosting productivity is simply the joint recognition by labor and management of the need for greater efficiency. This "consciousness-raising" has certainly characterized the automobile industry in recent years, and despite the large profits amassed by auto producers this year, the recently negotiated labor contracts demonstrate in important ways that the need for productivity improvement is still perceived. But there, as elsewhere, we need to see intentions and desires translated into tangible changes in production processes.

In sum, as we look to the latter half of this decade, great opportunities for strong economic growth are clearly within our grasp. To take full advantage of them, however, we shall have to bring real diligence to bear upon a number of thorny problems, a challenge that calls upon all parties--policymakers, employers, and workers--to put forth our best effort.