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The Basis for Lasting Prosperity

Address by

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Nearly three years ago, in a talk here in Los Angeles, I pointed out that once an economy becomes engulfed by inflation, economic policy makers no longer have any good choices. To regain a lasting prosperity, a nation must have the good sense and fortitude to come to grips with inflation. There is, however, no painless way of getting rid of the injustices, inefficiency, and international complications that normally accompany an inflation.

Events of the past several years have lent poignancy to these simple truths. Recent experience has demonstrated once again that the transition from an overheated economy to an economy of stable markets is a difficult process. Elimination of excess demand was an essential first step to the restoration of stability, but this step has brought with it a period of sluggish economic activity, slow income growth, and rising unemployment. And while we have made some progress in moderating the rate of inflation, our people are still seeing the real value of their wages and savings eroded by rising prices.

The struggle to bring inflationary forces under control, and to return our labor and capital resources to reasonably full employment, is still going on. I am convinced, however, that corrective adjustments in the private sector over the past twelve to eighteen months are creating, in conjunction with governmental stabilization policies, the foundation on which a prolonged and stable prosperity can be constructed.

A cardinal fact about the current economic situation, and one that promises well for our nation's future, is that the imprudent policies and practices pursued by the business and financial community during the latter half of the 1960's are being replaced by more sober and realistic economic judgments. In my remarks to you today, I want first to review some of the key developments that lead me to this conclusion. Then I shall turn to the tasks that must still be faced in order to enhance the prospects for an early resumption of growth in production and employment in an environment of reasonably stable prices.

The current inflation got under way in 1964. Perhaps the best single barometer of the extent to which it served to distort economic decisions and undermine the stability of the economy is found in the behavior of financial markets during the late 1960's. In 1968, well over 3 billion shares of stock exchanged hands on the New York Stock Exchange--about two and one-half times the volume of five years earlier. The prices of many stocks shot upward with little reference to actual or potential earnings. During the two years 1967 and 1968, the average price of a share of stock listed on the New York Exchange rose 40 per cent, while earnings of the listed companies rose only 12 per cent. On the American Exchange the average share price rose during the same two years more than 140 per cent on an earnings base that increased just 7 per cent.

A major source of the speculative ardor came from some parts of the mutual fund industry. Long-term investment in stocks of companies with proven earnings records became an outmoded concept for the new breed of "go-go" funds. The "smart money" was to go into issues of technologically oriented firms--no matter how they were meeting the test of profitability, or into the corporate conglomerates--no matter how eccentric their character.

This mood of speculative exuberance strongly reinforced the upsurge of corporate mergers which occurred during the middle years of the 1960's. No doubt many of these mergers could be justified on grounds of efficiency. But the financial history of mergers--including some of the great conglomerates--suggests that many businessmen became so preoccupied with acquiring new companies and promoting the conglomerate image that they lost sight of the primary business objective of seeking larger profits through improved technology, marketing, and management. When talented corporate executives devote their finest hours to arranging speculative maneuvers, the productivity of their businesses inevitably suffers and so too does the nation's productivity.

These speculative excesses had to end, and it is fortunate that they ended before bringing disaster to our nation. Equity values are now being appraised more realistically than a year or two ago. Investors are now more attentive to high quality stocks. Indeed, many of them have discovered or rediscovered that even bonds and time deposits are a fit use of their funds. Not a few of those responsible for the frantic search for "performance stocks" have shifted to other activities or joined the ranks of the unemployed; so also have numbers of security analysts and stock brokers. With speculation giving way to longer-term investment, the stock market is now channeling risk capital to business firms more efficiently.

A searching reappraisal of the economic philosophy of mergers is also underway. Merger activity has slowed materially since mid-1969. To some degree this is a response to the growing concern in governmental circles over the dangers that may inhere in large concentrations of economic power. But it stems mainly from the fact that businessmen are recognizing that time and energy can usually be spent more productively in searching for ways to increase the economic efficiency of their firm than in a scramble for corporate acquisitions.

Businessmen are also reconsidering the wisdom of financial practices that distorted their balance sheets during the late 1960's. In the manufacturing sector, the ratio of debt to equity--which had been approximately stable during the previous decade--began rising in 1964 and was half again as large by 1970. Liquid asset holdings of corporate businesses were trimmed to the bone. On the average, the ratio of prime liquid assets to current liabilities fell by nearly half during those six years. In permitting such a drastic decline in liquidity, many of our corporations openly courted trouble.

Perhaps the most ominous source of instability produced by these financial practices was the huge expansion of the commercial paper market. The volume of commercial paper issued by nonfinancial businesses increased eightfold between the end of 1964 and mid-1970, as an increasing number of firms--some of them with questionable credit standings--began to tap this market. The hazards inherent in the spreading reliance on commercial paper were taken much too lightly. After all, the relations between the buyer and seller of commercial paper are by their very nature distant and impersonal--unlike the close working relationship that normally develops between a bank and its business customers. The buyer--typically an industrial enterprise--rarely has the facilities or the experience to carry out a full investigation of the risks attaching to commercial paper. Moreover, the buyer regards his investment as temporary--to be withdrawn when cash is needed or when questions arise about the quality of the paper. The issuer, therefore, faces considerable uncertainty as to the amount of his maturing obligations that may be renewed on any given day. The risks facing the individual issuer and buyer inevitably pose a problem also for the nation's financial system, since the difficulties experienced by any large issuer of commercial paper may quickly spread to others.

These familiar truths were lost sight of in the inflationary aura of the late 1960's. It took the developments of last summer, when the threat of financial crisis hung for a time over the commercial paper market, to remind the business community that time-honored principles of sound finance are still relevant.

As a result of that experience and the testing of financial markets generally during the past two years, corporate financial policies are now more constructive than in the recent past. This year, new stock issues have continued at a high level--even in the face of unreceptive markets--as corporations have sought to stem the rise in debt-equity ratios. Of late, borrowing by corporations has been concentrated in long-term debt issues, and their rate of accumulation of liquid assets has risen. Liquidity positions of industrial and commercial firms are thus improving, though it will take some time yet to rectify fully the mistakes of the past.

These efforts to restore sound business finances are not without costs to the nation. For example, long-term interest rates, while below their peaks at the end of last year or last spring, are still at unusually high levels because of this year's extraordinary volume of new capital issues. But there can be no doubt that substantial adjustments in the financial practices of our nation's businesses were essential if the basis for a lasting and stable prosperity was to be re-established.

By and large, our major financial institutions conducted themselves with prudence during the years when lax practices were spreading in financial markets. There were, however, some individual institutions that overextended loan commitments relative to their resources, others that reduced liquidity positions to unduly low levels, still others that permitted a gradual deterioration in the quality of loan portfolios, and even a few that used funds of depositors to speculate in long-term municipal securities. Fortunately, such institutions were distinctly in the minority. When the chips were down, our major financial institutions proved to be strong and resilient. And they are stronger today. As monetary policy has eased, the liquidity of commercial banks has been increasing. Even so, loan applications are being screened with greater care. The emphasis on investment quality has also increased at other financial institutions, as is evidenced by the recent wide spread between the yields of high and lower grade bonds.

These corrective adjustments in private financial practices have materially improved the prospects for maintaining order and stability in financial markets. But no less important to the establishment of a solid base for a stable and lasting prosperity have been the developments this year in the management of the industrial and commercial aspects of business enterprise.

During the latter half of the 1960's, business profit margins came under severe pressure. The ratio of profits after taxes to income originating in corporations had experienced a prolonged rise during the period of price stability in the early 1960's. But this vital ratio declined rather steadily from the last quarter of 1965 and this year reached its lowest point of the entire postwar period.

Until the autumn of 1969 or thereabouts, the decline in profit margins was widely ignored. This is one of the great perils of inflation. Underlying economic developments tend to be masked by rising prices and the state of euphoria that comes to pervade the business community. Though profit margins were falling and the cost of external funds was rising to astonishing levels, the upward surge of investment in business fixed capital continued. True, much of this investment was undertaken in the interest of economizing on labor costs. Simultaneously, however, serious efforts to bring operating costs under control became more and more rare, labor hoarding developed on a large scale, huge wage increases were granted with little resistance, and some business investments were undertaken in the expectation that inflationary developments would one way or another validate almost any business judgment. While the toll in economic efficiency taken by these loose managerial practices cannot be measured with precision, some notion of its significance can be gained by observing changes in the growth rate of productivity.

From 1947 through 1966, the average rate of advance in output per manhour in the private sector of the economy was about 3 per cent per year. In 1967, the rate of advance slowed to under 2 per cent, and gains in productivity ceased altogether from about the middle of 1968 through the first quarter of this year. The loss of output and the erosion of savings that resulted from this slowdown in productivity growth are frightfully high.

The elimination of excess demand, which the government's anti-inflationary policies brought about, is now forcing business firms to mend their ways. Decisions with regard to production and investment are no longer being made on the assumption that price advances will rectify all but the most imprudent business judgments. In the present environment of intense competition in product markets, business firms are weighing carefully the expected rate of return on capital outlays and the costs of financing. The rate of investment in plant and equipment has therefore flattened out, and advance indicators suggest that business fixed investment will remain moderate in 1971.

Business attitudes toward cost controls have of late also changed dramatically. A cost-cutting process that is more widespread and more intense than at any time in the postwar period is now underway in the business world. Advertising expenditures are being curtailed, unprofitable lines of production discontinued, less efficient offices closed, and research and development expenditures critically reappraised. Layers of superfluous executive and supervisory personnel that were built up over a long period of lax managerial practices are being eliminated. Reductions in employment have occurred among all classes of workers--blue collar, white collar, and professional workers alike. Indeed, employment of so-called non-production workers in manufacturing has shown a decline since March that is unparalleled in the postwar period.

Because of these vigorous efforts to cut costs, the growth of productivity has resumed, after two years of stagnation. In the second quarter of this year, output per manhour in the private nonfarm economy rose at a 4 per cent annual rate, and the rate advanced to 5 per cent in the third quarter. These productivity gains have served as a sharp brake on the rise in unit labor costs, despite continued rapid increases in wage rates.

In my judgment, these widespread changes in business and financial practices are evidence that genuine progress is being made in the long and arduous task of bringing inflationary forces under control. We may now look forward with some confidence to a future when decisions in the business and financial community will be made more rationally, when managerial talents will be concentrated more intensively on efficiency in processes of production, and when participants in financial markets will avoid the speculative excesses of the recent past.

Let me invite your attention next to the role that government policies have played this year in fostering these and related adjustments in private policies and practices.

The fundamental objective of monetary and fiscal policies this year has been to maintain a climate in which inflationary pressures would continue to moderate, while providing sufficient stimulus to guard against cumulative weakness in economic activity. Inflationary expectations of businessmen and consumers had to be dampened; the American people had to be convinced that the government had no intention of letting inflation run rampant. But it was equally important to follow policies that would help to cushion declines in industrial production stemming from cutbacks in defense and reduced output of business equipment, and to set the economy on a course that would release the latent forces of expansion in our home-building industry and in state and local government construction. I believe we have found this middle course for both fiscal and monetary policy.

A substantial reduction in the degree of fiscal restraint has been accomplished this year with the phasing out of the income tax surcharge and the increase in social security benefits. These sources of stimulus provided support for consumer disposable incomes and spending at a time when manufacturing employment was declining and the length of the work-week was being cut back.

I do not like, but I also am not deeply troubled, by the deficit in the Federal budget during the current fiscal year. If the deficit had originated in a new explosion of governmental spending, I would fear its inflationary consequences. This, however, is not the present case. The deficit in fiscal 1971--though it will prove appreciably larger than originally anticipated--reflects in very large part the shortfall of revenues that has accompanied the recent sluggishness of economic activity. The Federal budget is thus cushioning the slowdown in the economy without releasing a new inflationary wave. The President's determination to keep spending under control is heartening, particularly his plea last July for a rigid legislative ceiling on expenditures that would apply to both the Executive and the Congress. However, pressures for much larger spending in fiscal 1972 are mounting and pose a threat to present fiscal policy.

Monetary policy this year has also demonstrated, I believe, that it could find a middle course between the policy of extreme restraint followed in 1969 and the policies of aggressive ease pursued in some earlier years. Interest rates have come down, and liquidity positions of banks, other financial institutions, and nonfinancial businesses have been rebuilt--though not by amounts that threaten a reemergence of excess aggregate demand. A more tranquil atmosphere now prevails in financial markets. Market participants have come to realize that temporary stresses and strains in financial markets could be alleviated without resort to excessive rates of monetary expansion. Growth of the money supply thus far this year--averaging about a 5-1/2 per cent annual rate--has been rather high by historical standards. This is not, however, an excessive rate for a period in which precautionary demands for liquidity have at times been quite strong.

The precautionary demands for liquidity that were in evidence earlier in 1970 reflected to a large degree the business and financial uncertainties on which I have already commented. It was the clear duty of the nation's central bank to accommodate such demands. Of particular importance were the actions of the Federal Reserve in connection with the commercial paper market last June. This market, following the announcement on Sunday, June 21, of the Penn Central's petition for relief under the Bankruptcy Act, posed a serious threat to financial stability. The firm in question had large amounts of maturing commercial paper that could not be renewed, and it could not obtain credit elsewhere. The danger existed that a wave of fear would pass through the financial community, engulf other issuers of commercial paper, and cast doubt on a wide range of other securities.

By Monday, June 22--the first business day following announcement of the bankruptcy petition--the Federal Reserve had already taken the virtually unprecedented step of advising the larger banks across the country that the discount window would be available to help the banks meet unusual borrowing requirements of firms that could not roll over their maturing commercial paper. In addition, the Board of Governors reviewed its regulations governing ceiling rates of interest on certificates of deposit, and on June 23 announced a suspension of ceilings in the maturity range in which most large certificates of deposit are sold. This action gave banks the freedom to bid for funds in the market and make loans available to necessitous borrowers.

As a result of these prompt actions, a sigh of relief passed through the financial and business communities. The actions, in themselves, did not provide automatic solutions to the many problems that arose in the ensuing days and weeks. But the financial community was reassured that the Federal Reserve understood the seriousness of the situation, and that it would stand ready to use its intellectual and financial resources, as well as its instruments of monetary policy, to assist the financial markets through any period of stress. Confidence was thus bolstered, with the country's large banks playing their part by mobilizing available funds to meet the needs of sound borrowers caught temporarily in a liquidity squeeze.

The role that confidence plays as a cornerstone of the foundation for prosperity cannot, I think, be overstressed. Much has been done over recent months by private businesses and by the government to strengthen this foundation. If we ask what tasks still lie ahead, the answer I believe must be: full restoration of confidence among consumers and businessmen that inflationary pressures will continue to moderate, while the awaited recovery in production and employment becomes a reality.

The implications of this answer for the general course of monetary and fiscal policies over the near term seem to me clear. The thrust of monetary and fiscal policies must be sufficiently stimulative to assure a satisfactory recovery in production and employment. But we must be careful to avoid excessive monetary expansion or unduly stimulative fiscal policies. Past experience indicates that efforts to regain our full output potential overnight would almost surely be self-defeating. The improvements in productivity that we have struggled so hard to achieve would be lost if we found ourselves engulfed once again in the inflationary excesses that inevitably occur in an overheated economy.

As I look back on the latter years of the 1960's, and consider the havoc wrought by the inflation of that period, I am convinced that we as a people need to assign greater prominence to the goal of price stability in the hierarchy of stabilization objectives. I have recommended on earlier occasions that the Employment Act of 1946 be amended to include explicit reference to the objective of general price stability. Such a change in that law will not, of course, assure better economic policies. But it would call the nation's attention dramatically to the vital role of reasonable price stability in the maintenance of our national economic health.

At the present time, governmental efforts to achieve price stability continue to be thwarted by the continuance of wage increases substantially in excess of productivity gains. Unfortunately, the corrective adjustments in wage settlements that are needed to bring inflationary forces under control have yet to occur. The inflation that we are still experiencing is no longer due to excess demand. It rests rather on the upward push of costs--mainly, sharply rising wage rates.

Wage increases have not moderated. The average rate of increase of labor compensation per hour has been about 7 per cent this year--roughly the same as last year. Moreover, wage costs under new collective bargaining contracts have actually been accelerating despite the rise in unemployment. In the third quarter of this year, major collective bargaining agreements called for annual increases in wage rates averaging 10 per cent over the life of the contract. Negotiated settlements in the construction industry during the same three months provided for wage increases averaging 16 per cent over the life of the contract, and 22 per cent in the first year of the contract. Nor is the end of this explosive round of wage increases yet in sight. Next year, contracts expire in such major industries as steel, aluminum, copper, and cans. If contracts in those industries are patterned on recent agreements in the construction industry--or, for that matter, in the trucking and automobile industries--heavy upward pressures on prices will continue.

I fully understand the frustration of workers who have seen inflation erode the real value of past wage increases. But it is clearly in the interest of labor to recognize that economic recovery as well as the battle against inflation will be impeded by wage settlements that greatly exceed probable productivity gains.

In a society such as ours, which rightly values full employment, monetary and fiscal tools are inadequate for dealing with sources of price inflation such as are plaguing us now--that is, pressures on costs arising from excessive wage increases. As the experience of our neighbors to the north indicates, inflationary wage settlements may continue for extended periods even in the face of rising unemployment. In Canada, unemployment has been moving up since early 1966. New wage settlements in major industries, however, averaged in the 7 to 8 per cent range until the spring of 1969, then rose still further. This year, with unemployment moving above 6-1/2 per cent, negotiated settlements have been in the 8 to 9 per cent range.

Many of our citizens, including some respected labor leaders, are troubled by the failure of collective bargaining settlements in the United States to respond to the anti-inflationary measures adopted to date. They have come to the conclusion, as I have, that it would be desirable to supplement our monetary and fiscal policies with an incomes policy, in the hope of thus shortening the period between suppression of excess demand and the restoration of reasonable relations of wages, productivity, and prices.

To make significant progress in slowing the rise in wages and prices, we should consider the scope of an incomes policy quite broadly. The essence of incomes policies is that they are market-oriented; in other words, their aim is to change the structure and functioning of commodity and labor markets in ways that reduce upward pressures on costs and prices.

The additional anti-inflationary measures announced by the President last Friday will make a constructive contribution to that end. The actions to increase the supply of oil will dampen the mounting cost of fuels, and the recommendations made by the President to improve the structure of collective bargaining in the construction industry strike at the heart of a serious source of our current inflationary problem.

I would hope that every citizen will support the President's stern warning to business and labor to exercise restraint in pricing and wage demands. A full measure of success in the effort to restore our nation's economic health is, I believe, within our grasp, once we as a people demonstrate a greater concern for the public interest in our private decisions.

If further steps should prove necessary to reduce upward pressures on costs and prices, numerous other measures might be taken to improve the functioning of our markets. For example, liberalization of import quotas on oil and other commodities would serve this purpose. So also would a more vigorous enforcement of the anti-trust laws, or an expansion of Federal training programs to increase the supply of skilled workers where wages are rising with exceptional rapidity, or the creation on a nation-wide scale of local productivity councils to seek ways of increasing efficiency, or a more aggressive pace in establishing computerized job banks, or the liberalization of depreciation allowances to stimulate plant modernization, or suspension of the Davis-Bacon Act to help restore order in the construction trades, or modification of the minimum wage laws in the interest of improving job opportunities for teenagers, or the establishment of national building codes to break down barriers to the adoption of modern production techniques in the construction industry, or compulsory arbitration of labor disputes in industries that vitally involve the public interest, and so on. We might bring under an incomes policy, also, the establishment of a high-level Price and Wage Review Board which, while lacking enforcement power, would have broad authority to investigate, advise, and recommend on price and wage changes.

Such additional measures as may be required can, of course, be determined best by the President and the Congress. What I see clearly is the need for our nation to recognize that we are dealing, practically speaking, with a new problem--namely, persistent inflation in the face of substantial unemployment--and that the classical remedies may not work well enough or fast enough in this case. Monetary and fiscal policies can readily cope with inflation alone or with recession alone; but, within the limits of our national patience, they cannot by themselves now be counted on to restore full employment, without at the same time releasing a new wave of inflation. We therefore need to explore with an open mind what steps beyond monetary and fiscal policies may need to be taken by government to strengthen confidence of consumers and businessmen in the nation's future.

In the past two years we have come a long way, I believe, towards the creation of a foundation for a lasting and stable prosperity. Confidence has been restored in financial markets. Businesses have turned away from the imprudent practices of the past. Productivity gains have resumed. Our balance of trade has improved. The stage has been set for a recovery in production and employment--a recovery in which our needs for housing and public construction can be more fully met.

To make this foundation firm, however, we must find ways to bring an end to the pressures of costs on prices. There are no easy choices open to us to accomplish this objective. But that, as I indicated at the outset, is the tough legacy of inflation.

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