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INVESTMENT OPPORTUNITY

Remarks of C. Canby Balderston,
Vice Chairman, Board of Governors of the Federal Reserve System,
Before the Finance Section, American Life Convention,
Chicago, Illinois,
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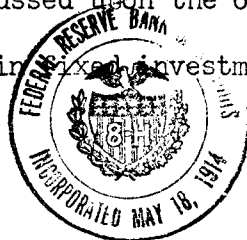
INVESTMENT OPPORTUNITY

In the fifteen years since the Second World War, the American economy, despite minor setbacks and some speculative excesses, has performed at high levels and has grown markedly. The record gives us reason to take satisfaction in our economic performance. In contrast, fifteen years after the conclusion of the First World War this country was in the midst of a major economic upheaval that had gotten under way some time before.

Many factors have contributed to the relatively well-sustained growth in our economy during this decade and a half. A large military establishment has been created: it entails high developmental and procurement expenditures. The so-called "built-in stabilizers" provided by variation in income tax levies, unemployment compensation, and other devices have been adopted. In addition, the economy has been supported by a high level of business investment in plant and equipment.

Saving continues to be necessary to support the world-wide craving for capital investment. And so at the 1957 meeting of the National Association of Life Underwriters, I took occasion to pay tribute to the skills of the insurance industry in merchandising saving and of its success as a savings vehicle. My suggestion then was that savings programs must be fitted to new requirements by the use of creative imagination.

This paper is focussed upon the other side of the coin: the analysis of postwar trends in fixed investment by business. Business



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investment is related to our economic growth in two ways. The distinction between them is one which is of central importance in understanding what has happened to investment in recent years. It is a distinction between the process of investing on the one hand, and the results of investing on the other.

The process of investing involves streams of orders and contracts, production, borrowing, and spending; as a process, investing contributes to the current demand for the nation's goods and services. When investment expenditures drop, the drop in demand has a depressing influence on the economy. When expenditures are high, as they have been on the whole during the postwar years, the economy is stimulated. It was this aspect of investment which preoccupied many students of the economy in the 1930's, when the level of capital spending was very low. At that time many of them viewed investment solely as a short-run stimulus to total demand.

In doing so, they tended to overlook the fact that business investment adds to the nation's stock of structures and equipment. Business investment has increased the capital stock needed to maintain and expand our industrial economy, and to make that capital stock responsive to improvements in technology and to shifts in the nature of final demands. An expanding economy requires not only a widening stream of spending, but also sufficient capital and other resources to translate spending into goods and services rather than into bottlenecks and price increases. This aspect of investment has received much attention in the current discussion of economic growth--so much, in fact, that there may be some danger of the pendulum swinging too far away from attention to the maintenance of a smooth

investment process. It is difficult, but necessary, to keep both aspects of investment in mind--the capital needed for expansion, and the process by which it is obtained,

We shall return to this distinction presently after an excursion to present an observation of my colleague, Frank deLeeuw of the Board's staff. He has noted that the postwar course of fixed investment spending and overall economic activity has had the relation depicted in Chart 1. The solid line in the upper portion of the chart represents the total gross national product and the dashed line represents business fixed investment. The two lines are plotted on different scales, arranged so that when they coincide, fixed investment is equal to 10 per cent of gross national product. The lines have in fact approximately coincided many times during the postwar period, and so the chart makes it apparent that business fixed investment has fluctuated around 10 per cent of gross national product.

Cyclically, as the chart shows, fixed business investment has followed roughly the same alternations of boom and recession as total GNP, but the amplitude of its swings has been greater. When GNP has risen, business investment has typically risen faster; when the former has fallen, the latter has dropped off still more sharply. Furthermore, business investment has tended to lag at the start of the postwar upswings, but once turned upward, it has advanced rapidly. In the last two years, although the advance has not quite sufficed to bring business investment up to the 10 per cent level, the gap has narrowed.

One of the forces producing these magnified fluctuations in fixed investment has been swings in the pressure of output against capacity. We

do not have data to illustrate these swings for the economy as a whole. We do, however, have the information pictured in Chart 2 for seventeen industrial materials. The chart is based on physical output and capacity data available for such materials as steel, cement, and petroleum.

The capacity line in Chart 2 appears to be quite smooth, and to rise at an average rate of a little more than 4 per cent per year. However, the drop in output beginning in late 1953 was followed by a slowdown in the capacity line in 1954 and 1955. After the 1954-55 rise in output came a pickup in the capacity line in 1956 that continued in 1957 and 1958. And the 1957-58 drop in output was followed by a perceptible slowdown in the expansion of capacity in 1959. These fluctuations in the rate of increase of capacity are shown more clearly in the bottom panel of the chart, where they are depicted as year-to-year per cent changes. The larger changes are more than twice as great as the smaller ones.

Now it is these changes in capacity rather than the levels of capacity that are related to net capital spending, or at least to a portion of such spending. Even though shifting pressures of output on capacity have apparently tilted the capacity line up or down only slightly, these slight alterations in slope represent quite large changes in the absolute amount of capital spending. Thus the postwar cycles in total output have been magnified in capital spending.

If providing new capacity were the only function of investment, however, investment would probably fluctuate even more than it actually does. A relatively stabilizing influence is provided by one of its other functions: the replacing and modernizing of the stock of capital. As Chart 3 shows--

though I should warn you that the underlying data are very rough--the replacement of worn-out or obsolete plant and equipment and the introduction of new production processes are believed to have reflected changes in business conditions, but generally their fluctuations have been less than those related to the expansion of productive capacity.

In Chart 3 as well as in Chart 2, it is apparent that each of the postwar cycles has had its own characteristics and that each has been distinctive. Chart 3 shows that during both the Korean expansion of 1950-53 and the post-Korean expansion of 1955-57, outlays for expansion were for a time above outlays for replacement and modernization. During the expansion of 1959 and 1960, in contrast, outlays for expansion have remained well below those for replacement and modernization. The preceding chart, No. 2, also shows a difference between the current expansion and those in 1951 and 1955-56. Capacity has been more ample during the current cycle than during the two earlier ones. While the chart refers only to selected industrial materials, other evidence indicates that similar, though less marked, widening of capacity margins has characterized much of the rest of the economy.

It seems likely, therefore, that the trends in the two charts are related. More ample capacity currently than in the early 1950's has meant devoting a smaller share of total outlays to expansion. This decline in expansion illustrates the two sides of investment referred to earlier. Rapid growth in output following the outbreak of the Korean War exerted pressure to increase a capital stock that had proven insufficient. The process of increasing the stock contributed to the general expansion. Meanwhile, the capital stock rose, defense spending leveled off, and eventually the results of the earlier investment relieved the pressure to increase capital outlays.

The growth in replacement and modernization is not simply a result of more ample capacity. It also reflects the real increase in depreciation and obsolescence, particularly the latter, which has accompanied the expansion of our stock of capital. One small but interesting example is afforded by changes in truck registrations as portrayed in the fourth chart. The number in the five-year-and-under group reached its peak in 1952; since then there has been a steady rise in the number in the older group until it now comprises two-thirds of the total.

The present age distribution of trucks, it will be observed, resembles the early postwar one. In this respect, however, the chart is probably not quite representative; on the whole, the emphasis on replacement and the ease in capacity margins appear to be even greater now than in the pre-Korean period.

At the same time, what information we have available as to output and capacity during the 1920's suggests that capacity margins during that period were not far from current margins. In a classic 25-year-old study of America's Capacity to Produce, the Brookings Institution put manufacturing output at an average of about 80 per cent of full capacity in the prosperous years 1925 to 1929. The margin during the current year is generally put slightly above this figure.

Turning now to the funds available for investment, Chart 5 shows that the flow of profits and depreciation allowances--that is, "internal" funds--have provided no obstacle to spending during the early stages of our cyclical expansions. It is typically in the later stages of capital spending booms that spending has overtaken internal funds, long-term corporate borrowing demand has been high and--as the bottom panel of the chart shows--interest rates on long-term bonds have tended to rise.

This chart also reveals the distinctive character of investment during the Korean and early post-Korean years; it was during these years that capital spending rose above internal funds for extended periods. In the first postwar expansion, capital spending and internal funds were similar in amount, but since 1958, internal funds have been somewhat the larger.

The term "internal funds" covers two broad sources of receipts: depreciation allowances, and profits after taxes and dividends. Between these two sources there has been a dramatic shift during the postwar years, which is depicted in Chart 6. Depreciation allowances were smaller than retained profits in each year from 1946 through 1951; by 1959, however, they were more than twice as great. This shift reflects changes in the treatment of depreciation in our tax laws, as well as the great postwar growth in the stock of capital that has been already mentioned.

Whether growth in depreciation contributes to stability is open to question, since such growth might simply transfer to profits the unstable portion of corporate receipts. The evidence of the chart, however, is that the drop in internal funds in the 1958 recession was no more steep than in earlier periods and was unusually brief.

There are other interesting and illuminating aspects to the postwar investment boom presented in the last two of the charts, Nos. 7 and 8. The first aspect relates to interest rates. Over the last few years bond rates have tended upward, although currently below the peak levels reached at the beginning of 1960. Generally speaking, the stream of spending

has been catching up with the high liquidity levels which existed at the end of the Second World War and which have continued to grow since then. Consequently, interest rates have risen. This deterrent to capital spending has been somewhat offset by a decline, slightly reversed currently, in the average dividends-price ratio on common stocks. But of the two, bond issues have been the more important as a source of corporate funds, and so the offset has probably not been complete.

On the whole the average dividends-price ratio has not departed too much from the average of the 1920's; but the bond rate in most of the postwar period has been lower. In fact, its early 1960 peak just about touched the low point in 1928. Here, then, is another respect in which the present situation represents a change from the early 1950's and greater kinship with the 1920's. Of course, the higher rates of taxation in recent years distort such a long-term comparison.

Finally, consider the most imponderable of all the influences--research and development activity. Of the new products that have come of age during the postwar years--electronic computers, television and other communication equipment, new drugs and medicines, synthetic rubber, many synthetic fibers and plastics, jet engines and other military equipment of all kinds--it is astonishing how many of them sprouted during the Second World War. It would seem that much postwar productivity growth has capitalized on war research.

On the other hand, the eighth chart showing research and development expenditures reflects how the amount of resources devoted to research has increased every year. The late Kenneth Mees, research director of Eastman

Kodak, concluded that technology has been accelerating at a rate that has itself been accelerating. Has this trend ceased for the moment, and are the returns from product and process research diminishing? Or in view of the lag between initial breakthrough and mass production, is the stream of new products and methods likely to grow in the years ahead?

Inferences

Despite the gaps in our knowledge of the long-term influences on business investment, we can nevertheless summarize our observations and draw certain inferences that may help to give us our bearings. During much of the postwar period, especially the Korean and early post-Korean years, the need for additional plant and equipment has been very high. Compared to the 1920's, margins of excess capacity have been smaller and interest rates on long-term bonds lower. With new processes and products adding to this need for new capacity, there has been steady growth in fixed capital outlays. In the last few years, capacity has become more ample in relation to output, business demand for external financing has receded, and at the same time growing needs of other borrowers have caused bond rates to rise. As a result, there has been a decline in the growth of investment--either when compared with its own earlier growth or with total gross national product (see Chart 1).

In addition to these depressants, however, the present situation is marked by certain positive features. A growing volume of investment apparently is needed to offset the retirement of worn out and of obsolete equipment. Business depreciation allowances have reached high levels, and they might possibly have a stabilizing effect on investment expenditures. Finally, national spending for research and development is at record levels,

and may be expected to promote new products and processes requiring new types of plant and equipment.

What may one infer as to recent trends? We are not, of course, able to predict the future of investment with precision. But some insight into the over-all business investment situation may be gained from the distinction drawn at the beginning of this discussion--that between the process of investing and its results.

With respect to the process of investment in plant and equipment--the flows of orders, production and shipments--we have seen in recent years a leveling off. Dampening influences that have slowed down investment have lessened this stimulant to the growth of the economy.

On the other hand, with respect to the results of investment--the adequacy of the nation's capital stock,--we are in a much better position than we have been in any of the earlier postwar years. The present position bears some similarity to that of the 1920's, and we can achieve considerable expansion without running into bottlenecks and price pressures related to plant and equipment.

This combination of an ample stock of capital and a less buoyant flow of new investment is the reverse of the situation typical of the postwar period as a whole and especially of the early 1950's. These trends may again be reversed, as replacement and modernization outlays grow or as expansion in other streams of spending gradually push output close to capacity again. As long as they last, however, current trends represent a change in the character of investment that bears upon the economic outlook, inflation, and economic growth.

One should not conclude from the foregoing observations that the need for saving has in any way diminished. Indeed, we will be unable to achieve the economic growth to which we aspire unless we provide through savings for enlarged productive facilities in the future. To this end, careful and alert guidance is needed to allocate the savings stream to the most urgently needed capital developments.

There are many evidences of obsolete and worn out physical plant all around us in this country. Moreover, the pace of technological change has never in all history been so rapid and this is providing fresh openings for industrial capacity adapted to new processes and products. Besides this, we face the need to invest aggressively to keep competitive with the rest of the world. In underdeveloped countries, lastly, there is a desperate desire for the fruits of industrialization to raise the standards of living by furnishing water, schools, and houses with better than earth flooring.

And so the struggle to save enough to undergird technological advance goes on in all countries able to produce more than they consume. But changes in the most effective use of saving must be taken into account by all those responsible for investment policy. These changes are sufficiently acute to merit close analysis and the active search for promising opportunities.

Chart 1
BUSINESS FIXED INVESTMENT

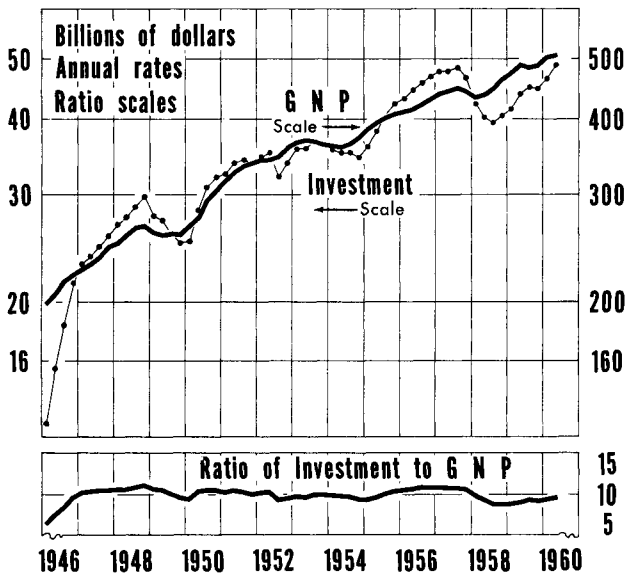


Chart 2
MAJOR MATERIALS

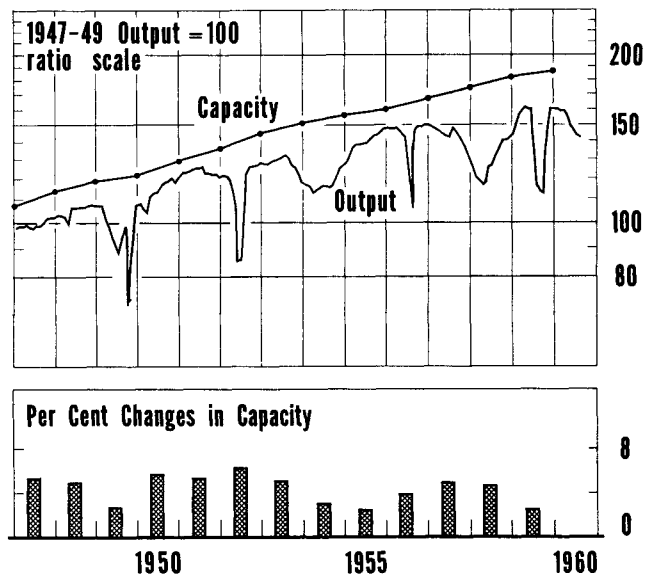


Chart 3
CAPITAL OUTLAYS — MANUFACTURING

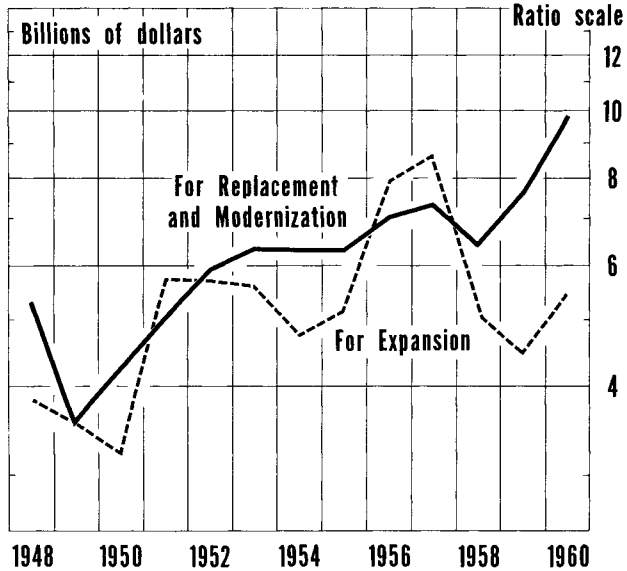


Chart 4
TRUCK REGISTRATIONS

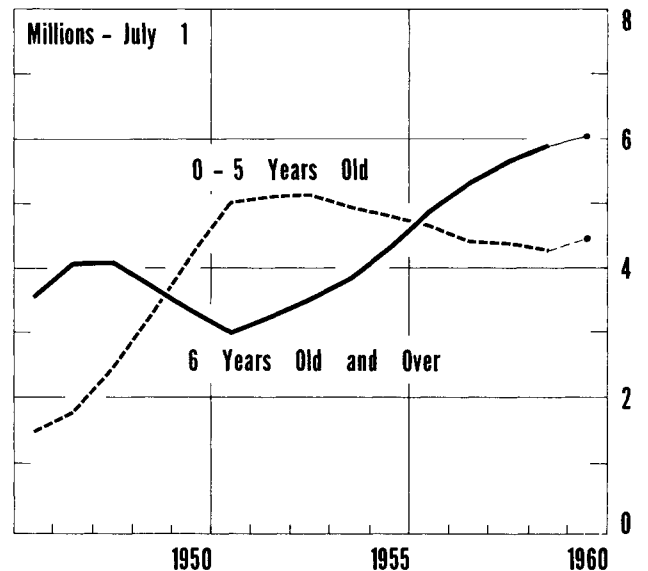


Chart 5
CORPORATE FINANCE

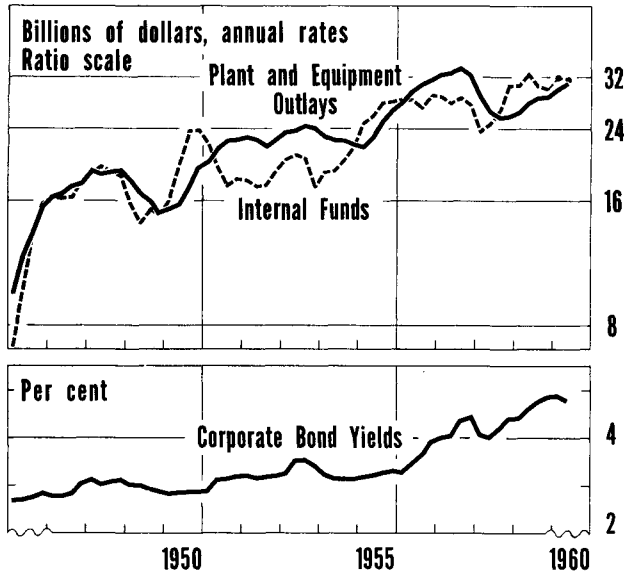


Chart 6
CORPORATE INTERNAL FUNDS

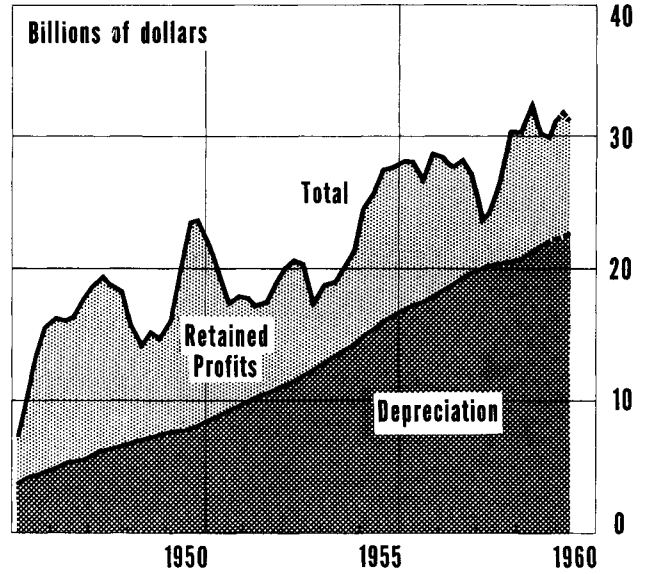


Chart 7
CORPORATE SECURITY YIELDS

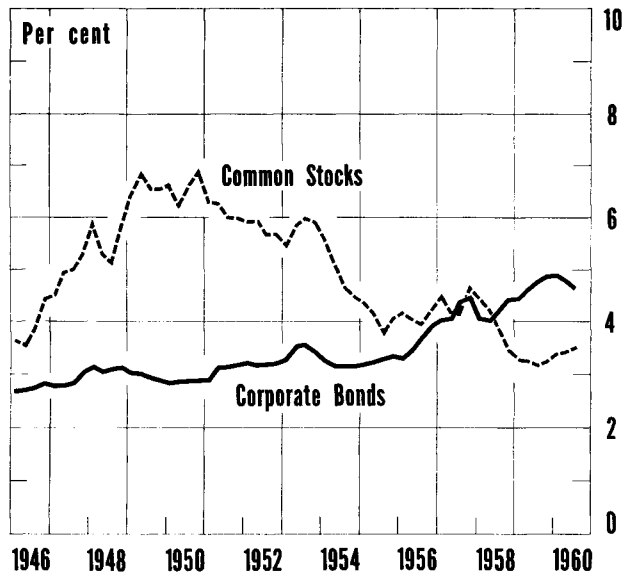


Chart 8
RESEARCH AND DEVELOPMENT

