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The Reinvestment Objective: A Role for Monetary Policy?

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I appreciate the opportunity to appear before your group: you represent an industry which was one of the first to lead the recovery and your performance has quickly put you face to face with the limits of productive capacity. Thus, you symbolize one of the dilemmas extant with the second year of the current business expansion. There is the need, on one hand, for growth to restore market shares both domestic and international and to generate cash flow for investment in capacity. On the other hand, rising intentions to put plant and equipment in place pose the real question for public policy of whether financing business fixed investment will force an early return to significantly higher rates of inflation.

Nothing has been quite as expendable as the forecasts done this time last year--those centered around an outlook for weak investment in the face of high real interest rates. It could be said of 1983 that we had both a consumer boom and a business fixed investment revival. It should have been no surprise that capital spending began to pick up in the second half of 1983, followed by further augmentations of both equipment production and industrial construction--even though this momentum rose from one of the lowest investment levels in the post World War II period.

Perhaps a fault in the outlook a year ago was a function of the awareness that we have had underinvestment in productive facilities in this country over the past few years. Indeed the magnitude of the task of rebuilding our industrial

and services capabilities, not to mention our road, rail, bridge, and airport infrastructure is an enormous one. We have too long lived in a cycle of stop-go and slow growth, of high inflation and negative productivity. Surely the question of whether we have embarked upon a sustainable recovery, one of a three or even four year duration, turns in part upon the durability and depth of business fixed investment spending. We cannot forever rely upon consumers even though their confidence is at a five-year high.

Thus the question in the minds of many forecasters today is whether this cyclical recovery/expansion will abort from increasing interest rates and the collision of federal mega-deficit spending with rising private credit demands. Some analysts have anticipated the emergence of a new business cycle pattern--that the short succession of recessions of 1980-81 will be repeated.

For a balanced outlook, it is noteworthy that the surprises of this current expansion largely have been favorable. Four million jobs added in an early and a substantial recovery in "real" equipment investment, industrial production, housing starts, capacity utilization, and the sales of Detroit's products. Consumer prices, producer prices for finished goods, and compensation per hour all suggest continued moderate inflation. However, price indices of raw materials and sensitive materials may signal trouble.

There are, of course, other clouds on the horizon-- inventory restocking will further augment aggregate demand: we are far below the "stock" levels of previous recoveries. Discounting price increases, real imports may be growing ten times as fast as real exports this quarter. On balance, however, the structure of the recovery to this point has sources of strength that may underpin a normal period of expansion with continued relative price stability.

A key source of strength has been the decidedly upward trend in output per hour--labor productivity has grown appreciably since mid-1982 after years of decline or stagnation. Of course, relatively good productivity growth is typical of the early stages of recovery. However, this cycle's rise has some new elements as a result of the adversity of the last recession--the severity of the foreign competition, worker layoffs, and plant closings. Overhead has been reduced in most organizations. There are signs of a new commitment and cooperation between labor and management, and a willingness to attack the old rigidities and reduce costs through new efficiencies in production, lower overhead, and more flexible work rules and hiring practices--an aluminum plant expands output with one-third less workforce; a maintenance worker doubles both on the assembly line and the warehouse. Some management has involved labor in locating new plants and the expansion of existing ones, as well as in the considerations

which go into closings. Union leadership in industries under the pressures of very low capacity or deregulation have gone beyond concessions in wages and benefits to changes in work rules and prerogatives lying outside compensation.

Lower break-even levels for business, together with growing markets, have accounted for an encouraging improvement in business cash flow--so much so that internally generated funding more than financed capital expenditures of nonfinancial corporations in 1983. By the second half of last year, the share of corporate business output represented by after-tax profits exceeded its share for any year in the 1970s.

In this sixteenth month of recovery, there are the first signs that the consumer may be tiring, his deferred purchases made up, and the first monthly payments of an augmented debt burden arriving in the same mail delivery as his higher property tax and state income tax notices. Equipment spending by business continues apace, but investment in electronic gear and retrofitting can only go so far in sustaining growth. At this stage, we need a more healthy buildup of office expansion and the actual creation of new facilities.

Various surveys indicate that the buildup may occur. Boards of directors are properly cautious, however, as high real interest rates translate into high "hurdle rates" of return on proposed new assets. Management argues after-tax returns and investment tax credits, but there is

Congressional discussion of the whole of the 1981-1982 business tax changes. Then there are the political/financial risks on the horizon which tend to deter the buildup further.

Business is aware that there are exceedingly complicated political decisions in train at a time when all political figures are under media and voter scrutiny. Americans are not accustomed to the consideration of international developments as major forces and factors. The news of a single month trade deficit of \$9 billion, a second round of Latin American debt negotiations, foreign purchases of private and public U.S. securities, and domestic banks that draw upon the Euro-markets, all have a slightly alien sound for many.

It is the essence of responsible public policy determination to learn the lessons of history and to be alert and concerned with aspects of economic growth which could have the most negative consequences. Thus, there are today extended discussions of federal deficits, of rising tax burdens, of protectionist measures overseas, and of fundamental "reform" of the whole tax system to a "flat," yet partially progressive tax on individuals and businesses. Prospective change means uncertainty, and uncertainty translates into a higher required return rate, inhibiting investment.

To me, these are some of the factors which suggest a certain vulnerability in business spending which may have been obscured by the flood of good economic news in the past 60

days. A similar caveat is appropriate related to the housing boom. Adjustable rate mortgages with builder subsidies cannot forever fuel housing demand. The course of our country's history is milestoned by surges of credit (note 1983 and mortgage credit) and rude awakenings from foreclosures and nonpayments as credit quality turns out to be the stuff of crisis management.

I believe that monetary policy cannot be structured nor its implementation accomplished without careful monitoring of those characteristics and vulnerabilities present on the scene (or in the wings) for 1984 and 1985. Likewise, it would be unwise to ignore potential inflationary implications if it becomes reasonably clear that the economy is moving along a track of not one, but several quarters of, say, 6 percent real growth. Recent recoveries have been of the one-quarter-up, next-quarter-rather-flat pattern. However, it is not out of the question that the domestic and international reefs and shoals can be avoided. Strong growth can conceivably surmount the regional and industrial sector imbalances of 1983's recovery. Indeed, when have we had an econometrically perfect balance leading into expansion? Imbalances and underutilization of resources are inherent in the process Schumpeter called "creative destruction."

This is to say that the major concerns for monetary policy and for its operations in 1984 are somewhat different

from the last two years. Monetary policy in 1983 was complicated by awareness of erratic behavior, beginning in 1982, of "velocity," the relationship between narrowly defined money, M1, and the pace of economic activity, as well as by the insertion therein of new types of deposit accounts.

The initial effects of the new accounts should be largely behind us. However, one of the major questions we still had to face earlier this year was whether to restore M1 growth as a key policy guide. In the second half of last year, M1 and its velocity with respect to GNP began to behave more in line with historical experience. Accordingly, the target range of 4 to 8 percent growth set by the FOMC for this year has a bit more weight. If its behavior continues to resemble earlier patterns, M1 could reasonably be regarded as predictable and useful in the future. However, in view of the fact that M1 includes relatively new accounts--the NOWs and SuperNOWs--which are markedly different from traditional checking accounts, their inclusion will continue to give rise to uncertainties at the present time as to the relationships between that aggregate and the economy, interest rates, and price expectations.

In a near-term, monetary policy can contribute to the outlook for strong, stable growth. Long-term reinvestment and, to some extent, even that of the near-term, is seriously jeopardized, however, by the consequences of our current

gargantuan and unprecedented federal budget deficits, and more importantly, by the even larger deficits projected for years to come.

The resulting imbalances and some of the deleterious repercussions are already apparent. While the deficits have supported and strengthened demand for goods and services, federal government borrowing needs have drained off an extremely large portion of available net savings in the economy. Their increasing collision with rising private credit demands has kept real interest rates, however measured, much higher than in previous postwar recoveries.

To be sure, those high interest rates have been one factor among several attracting a volume of foreign investment funds. These capital inflows have served to finance part of the budget deficit, leaving other funds available for expansion of our main capital--our services, housing, and business investment. However, high real interest rates, by making dollar-dominated securities more attractive to foreign investors, help push the exchange value of the dollar up and weaken the competitiveness of our export industries. The burgeoning imbalance of our foreign trade--a deficit of roughly \$65 billion in 1983 and something approaching \$100 billion for 1984--indicates both the attractiveness of investment here as well as a potential future consequence of added market instability.

There are, however, both positive and negative implications related to the substantial inflow of foreign capital into the U.S. In part, foreign investment in plant, equipment, real estate, and farm land preserves or increases employment and, in some cases, productivity. Japanese-U.S. auto plants are obvious examples of this. Yet we have been a net creditor nation for much of our recent history. If forecasters were surprised at the extent of our business investment boom so early in the recovery stage, imagine their astonishment at the proportion financed by foreigners.

Concern is warranted, of course, where foreign holdings are in short-term, highly liquid assets--we had the same concerns when the trade balances of the OPEC nations escalated a few years back. However, some analysts, including Wharton Econometric, argue that foreign investment is likely to be long term.

In addition, there is no inevitability to the forecasted levels of either the merchandise trade or the current account deficits which characterized 1983 and early 1984. A weaker dollar will, in time, raise exports. The rates of growth and, with them, the investment opportunities of our trading partners are improving. Creditor balances held abroad, of course, require interest payments, but those may be offset by foreign purchases as well as additional investment here. In the meantime, the world's largest market is

providing the dollars for foreign goods which enable countries and companies to service their dollar-dominated debt.

Monetary policy alone cannot address the imbalances in the expansion nor the fiscal deficits. It can help sustain solid economic growth in the short run and move us closer to price stability in the long run, but it can't, by itself, ensure adequate investment spending and a productive, balanced economy necessary for sustained growth and lower unemployment rates. Budgetary and international trade policies are the largest components of solutions to those opportunities.

It is encouraging that the focus of political attention to fiscal policy is now to those ways in which we can begin to resolve the dilemma of expenditures which are compounding at a faster annual rate than revenues. Contrast this with past presidential election years in which the discussion was largely concerned with what substantial new spending programs could be structured to deal with the myriad of social and economic problems.

It may be that we are underestimating the duration or sustainability of this economic expansion, just as we had underestimated the recent rates of real growth and the ability of a growing economy to absorb four million more employees. The opportunity for a sustained expansion is there. The difficulty in realizing that opportunity is that so many of the relationships of the old order have given way to new ones not

yet completely understood. Monetary policy can make its contribution through encouraging disinflation over the course of the business cycle, while at the same time providing adequate liquidity and enough credit and "money" to make possible a sustained expansion, buttressed by business fixed investment, and the longer range restoration of productive capacity necessary for our global competitive position.