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# THE BUSINESS CYCLE AND THE FEDERAL RESERVE

Remarks by

Henry C. Wallich
Member, Board of Governors of the Federal Reserve System

at the

1977 Annual Meeting of the

National Association of Business Economists

Philadelphia, Pennsylvania

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It is a pleasure to speak to the Annual Meeting of the National Association of Business Economists on the subject "The Business Cycle and the Federal Reserve." I shall begin with some comments on the general cyclical situation and Federal Reserve policy. Thereafter, I shall discuss what appears to me the single most crucial issue for the economic outlook: the outlook for business fixed investment.

The current business expansion has proceeded in an environment characterized, I believe it is fair to say, by a fair degree of consensus on matters of economic policy that during past expansions have been subjects of controversy. First, there seems to be a widespread, although not complete, consensus that the alleged trade-off between unemployment and inflation is not an appropriate basis for policy.

There may be such a trade-off for a few months or even quarters. There is none in the longer run. Over the years, in fact, inflation and unemployment have moved up together so that one could speak of a positively sloping Phillips Curve. That is how we eventually reached a condition of double-digit inflation and nearly double-digit unemployment. We have moved down some distance from those levels, but both unemployment and inflation are still unacceptably high. There is a degree of consensus, however, to the effect that we cannot fight one evil while ignoring the other. Both unemployment and inflation must be brought down simultaneously.

I believe that there is a degree of consensus also with respect to the appropriate rate at which the economic expansion ought to proceed. It should be a moderate rate of expansion -- I do not call it "growth" because that to me denotes a growth of capacity, not higher utilization of existing capacity. That, indeed, seems to be widely expected for the period ahead and seems to be widely regarded as appropriate.

On former occasions, I seem to recall, the argument was frequently made that the presence of substantial excess capacity justified and indeed called for a rapid rate of expansion, in the 6-8 per cent range. According to that prescription, such a sprint was to be followed by quick fiscal and monetary restraint as the capacity ceiling was being approached to slow the economy down to its long-run potential growth rate. Such attempts to accelerate the economy even after it was well into a cyclical expansion had caused the economy to slam hard into the capacity ceiling, generating inflation and subsequent recession. Today it seems to be widely recognized that fine-tuning is beyond our powers. In the present expansion, the need for moderation is underscored by the still very high level of inflation.

There is a high degree of consensus also, I believe, on the need to bring down inflation and not to accept the present high level. Inflation today is widely recognized as causing severe damage, to investment, to consumption, therefore to employment, and to our social and financial institutions generally. I hear much less frequently the view that a stable rate of inflation such as we have had for the last two years, with some ups and downs, can be regarded as the equivalent of price stability. I would be greatly concerned if such a view took hold because once it were believed that 6 per cent is as good as zero, it would only be a matter of time before we would be told that 1 per cent over 6 was nothing, that 2 per cent over 6 were quite acceptable, and so forth.

I might become guilty of occupational bias if I were to claim that there seems to be a greater consensus also on monetary policy. Certainly, there is greater agreement today that the monetary aggregates must be the major guide to policy. That is in the main the consequence of inflation, which makes the money supply a more compelling guide than interest rates. But outside the Federal Reserve there are, of course, those who argue that of late the aggregates have moved faster than consistent with bringing down inflation, matched by others who argue that they have not moved fast enough to prevent a rise in short-term interest rates. The Federal Reserve is in the middle, and I would merely point out that so far at least the course of the aggregates has been consistent with a stability of long-term interest rates remarkable for this stage of the cycle. I would add that if we interpret long-term interest rates in real terms, and make allowance for the fact that to most private debtors interest payments are tax deductible, real long-term rates are indeed very low and for many borrowers probably negative.

The continuation of the expansion at an adequate rate depends on a balanced advance of the major components of aggregate demand. The expansion is now well into its third year and, therefore, no spring chicken among its kind. But I do not believe that expansions typically die from old age. Historically they have died from imbalances. Something -- inventory accumulation, business investment, housing, durables consumption -- has gone off the rails, usually first on the upside and then on the downside.

The present expansion has not produced any major upside imbalances. It is experiencing two significant downside imbalances: the trade deficit, and the slow advance of business fixed investment. As for the trade deficit of about $30 billion for the first eight months at an annual rate, this is reflected in the national accounts in negative net goods and services exports of "only" about $8 billion, because net military transactions and services that enter the GNP accounts bring in some $21-23 billion. Historically, net exports have been a positive factor in the GNP accounts, and their current shortfall must currently be compensated by other elements that are strong.

That consideration adds further importance to the role of business capital spending. The rise in this sector from the economy's cyclical trough has been only about half what it has been on past occasions. I shall examine possible explanations of this performance.

Does Business Have the Money?

Are business cash flow and liquidity sufficient for a higher rate of capital spending? The answer is "on the whole, yes." Business cash flow is substantial, equaling $129 billion or 7 per cent of GNP for domestic nonfinancial corporations in the second quarter of this year. Based on past cyclical experience, a cash flow of this magnitude would be consistent with about $20 billion more in business fixed investment than that which actually occurred in the present recovery. The liquidity position of business likewise has improved, with less short-term debt, relative to long-term debt, at least until quite recently, and less debt of all kinds relative to equity. These liquidity gains, to be sure, to some extent reflect a deliberate preference for liquid assets over plant and equipment.

Nevertheless, it is worth noting that some of our largest enterprises have experienced a fundamental change in their financial structure. From a condition of low bonded indebtedness and almost pure equity financing, some enterprises during the 1960's moved to a higher debt/equity ratio, because at the time that appeared to promise higher profits. Whether the promise was fulfilled or not I need not examine here. The consequence, however, is that firms like these cannot at the present time engage in a great amount of additional debt financing without also increasing their equity.

A second reason for low investment could be that business may feel no great need for new investment. The rate of capacity utilization in manufacturing currently stands at about 83 per cent. Pressures on capacity, with attendant bottlenecks and shortages, typically have been felt at around 88 per cent. Thus there is not a great deal of excess capacity available. If we put 4 per cent additional capacity in place over the next year and simultaneously were to experience a rise in industrial production of about 9 per cent, which would reflect an expansion in GNP of about 6 per cent, somewhat stronger than seems likely, we would a year from now be operating at nearly 87 per cent of capacity. One good year's growth, in other words, would pretty much chew up the present excess capacity unless new capacity comes on stream at a quickened pace.

Our present rate of growth is not quite that rapid, and absorption of spare capacity accordingly may take longer. But neither are we putting in place all that much additional capacity. The projected growth of plant and equipment spending for 1977 of 13.3 per cent amounts to perhaps 6-7 per cent increase in real terms. It implies an increment to the economy's productive capacity in manufacturing of quite possibly somewhat less than 4 per cent, though probably more than 3 per cent. Thus, some capacity pressures might be felt in particular sectors sometime within the next year and a half.

The present level of 83 per cent capacity utilization has indeed historically been close to the trigger point for accelerated capital spending. It seems to be indicative of the level at which many businesses begin to feel the need for additional capacity, given the lead time it takes to bring it on stream. There has been one instance, the 1959-60 recovery, in which capital spending did not take off after reaching 83 per cent of manufacturing capacity. But that recovery was unusually weak by historical standards, as capital spending lagged somewhat from the start.

In every particular situation, both with respect to a single business and with respect to an entire economy, there are, of course, special factors to be considered. One special factor right now is the large amount of investment that will be needed not to expand capacity but to meet the requirements of the environment and of health and safety. Such expenditures accounted for about 5 per cent of private industry's outlays for plant and equipment in 1976. Some part of our existing capacity, moreover, may have been made obsolescent by the sharp rise in the price of energy. Both factors suggest that the amount of investment required may be larger and that the time at which it should be initiated should be earlier than in the past.

On the other hand, there is a great deal of excess capacity in basic industries in other countries around the world. Domestic bottlenecks could conceivably be met by larger imports, at a cost, of course, to our balance of payments and to our share in markets. World excess capacity could be considered as a factor working toward postponement of business capital spending.

## The Level of Profits

Corporate book profits as stated in the national income accounts have made a good recovery reaching $174 billion or 9.3 per cent of GNP in the second quarter of 1977. This is only half a per cent away from the average of the 1960's, which spans the historically low profit/GNP ratios of the early 1960's and the high ratios of the mid-1960's. I might add parenthetically that this corporate profit figure includes some $6.2 billion of profits of the Federal Reserve System, in addition, of course, to profits of other financial corporations and profits transferred from abroad.

This profit figure does not take into account, however, adjustments to be made for inventory valuation and capital consumption as also recorded by the Department of Commerce and implied by notes in 10-K statements required by the SEC. Such adjustments bring profits for the same quarter down by about 20 per cent or to 7.5 per cent of GNP. These massive overstatements of operating profits are the result, of course, of inflation. Taxes are paid largely on unadjusted profits.

Further adjustments could be made by applying the principles of general price level accounting (GPLA) or current value accounting (CVA). GPLA adjusts profits for, among other things, the gain or loss from inflation on the "net monetary asset position," i.e., for the gain of a debtor from the reduction through inflation in the real value of his net debt. CVA adjusts additionally for changes in the market value of assets and in particular the decline in market value of bonds issued at interest rates lower than the high rates typically prevailing during inflation.

Using 1975 domestic profits of U.S. nonfinancial corporations, the $102.3 billion of conventional profits before tax are reduced by GPLA to $68.0 billion of which operating profits are only $43.9 billion and gains on net monetary position $24.1 billion. CVA produces, for 1975, total profits of approximately $146.0 billion of which only $73.0 billion are operating profits. The impression that CVA is not a particularly good guide to what happens to corporate profits during inflation is strengthened by the fact that for 1974 this method of adjustment raised conventional profits before taxes from $102.9 billion to $193.1 billion, of which $55.7 billion were operating profits.[1/] The stock market seemed to think otherwise.

These bookkeeping profits from depreciation of debt in terms of purchasing power or in the market unfortunately produce no cash flow for business. If they were meaningful, one would expect the stock of many highly leveraged corporations, especially those with large amounts of low interest debt, to sell at a premium in the market. This, to my knowledge, is not the case. In fact, the stock market, by putting relatively low price/earnings ratios on many stocks, seems to be telling us that the earnings of these corporations are not worth as much as they seem.

Some further insight into the profit picture can be obtained by looking at the share of profits in GNP and at the return on corporate capital. The fact noted above that the share of profits in GNP has fallen does not by itself prove that the return on corporate capital as a whole has also fallen. Today, a much larger part of business investment than formerly is financed with debt. Consequently, the part of the return to capital that goes to equity holders would be smaller even if the share of total capital income in the GNP had remained unchanged.

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1/ See Richard Kopcke, New England Economic Review, October 1976, for method of calculation. Differences between Kopcke's figures and those shown here reflect subsequent revisions in Department of Commerce estimates of conventional profits.

The experts are not agreed as to whether or not the share of capital as a whole has indeed fallen, nor on whether or not the rate of return on this capital has fallen, in any permanent sense, if capital is measured by book value. There can be no doubt, however, that the rate of return has fallen if corporate capital or net worth is measured on a replacement cost basis. That, it seems to me, is a more realistic approach. On a replacement cost basis (not making allowance for gains from net monetary asset position), the rate of return today stands far below the 1960's.[2/]

One can look at this drop in the return on capital in two ways. One interpretation says that the drop reflects a fundamental trend in the economy. Capital, according to this view, has become less productive, which has reduced the demand for it, and thus has lowered the price paid for its services. The other way is to note that this analysis conflicts with the presumption that maintenance of our historic rate of growth requires a higher rather than lower rate of investment. According to that view, a faster rather than a more slowly rising stock of capital is needed, if not immediately, then probably in the near future. This needed investment is unlikely to be undertaken unless it yields an adequate return. That suggests

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2/ George Terborgh, Corporate Earning Power in the Seventies: A Disaster, Machinery and Allied Products Institute, August 1977.

that the underlying demand for new investment is there but that businessmen have not been able to convert it into projects that adequately cover their capital costs.

From the fact that the return on existing capital, measured as the average product of capital, is low today, it does not follow that the return on new investment, i.e., on capital measured at the margin, must also be low. To be sure high energy and environmental costs may have impaired the marginal product of capital. But if those are right who believe that continuation of our historic rate of growth requires a higher rate of investment than in the past, technological and price adjustments may be ahead that would raise the marginal product of new capital relative to that of the old capital.

Whether the return on new investment today is historically low or not, the significance of this rate of return cannot be fully evaluated without looking at the cost of capital. The cost of capital, today, presents a peculiar and complex picture. For most firms, the cost of capital consists of a combination of the cost of debt and the cost of equity, in the proportions in which the firm finances through borrowing, new equity issues, and retentions. At present rates of inflation, which, of course, need not be expected to persist into the indefinite future, the inflation premium in a 9 per cent bond is of the order of perhaps 5 per cent, allowing perhaps one per cent for risk and perhaps 3 per cent for the real interest component. Since the entire interest is tax deductible to a corporate borrower, the cost of debt capital taken by itself may well be negative today.

The cost of equity capital -- for purposes of capital budgeting this must be applied to investment from retentions as well as from new issues -- is high today. That is the message conveyed by the prevailing low price/earnings ratios on corporate stock. This message needs to be qualified, however. The market may be setting present P/E ratios on the basis of expected future earnings materially different from today. Furthermore, the market probably adjusts present earnings for inflation. Inflation-corrected P/E ratios may conceivably be higher and the inflation-corrected cost of capital lower, therefore, than would appear from the stock market page.

A rough judgment of the adequacy of profits in the light of capital costs is provided by a juxtaposition of the net worth of U.S. corporations computed on the basis of the replacement cost of their assets with the valuation of assets implicit in the bond and stock market. Today, this financial market valuation of enterprise falls well short of the replacement cost of its assets.[3/]

3/ J. Tobin and W. Brainard, "Asset Markets and the Cost of Capital," Economic Progress, Private Values and Public Policy, ed. B. Balassa and R. Nelson (North Holland: 1977), pp. 235-262.

Under these conditions, the firm can acquire additional assets and capacity more cheaply by purchasing an already existing firm than by building a new plant. Mergers, takeovers, and even repurchase of the firm's own stock become a more rational use of money than new capital spending. The ratio of replacement cost to stock market valuation of assets historically has been negatively correlated with the level of business fixed investment. Today, that relationship actually considerably underpredicts the existing level of capital spending. The valuation of assets in the market, based on expected earnings and on risks, apparently is so adverse that it does not even appear to justify the present sluggish rate of investment.

I have devoted considerable space to an examination of the determinants of business fixed investment because it occupies so central a position in the business outlook. The influences surveyed point to three possible scenarios. If low rates of return and high cost of capital were to dominate the situation, investment would remain sluggish and would fail to give needed support to the expansion. Second, if the prospects of pressures on capacity that are now emerging were to lead to moderately accelerated capital spending, that would carry the expansion forward while other sectors possibly subside. Such a development would make for a longlived expansion. Third, if response to capacity pressures is delayed until bottlenecks and shortages are actually upon us, we might eventually find ourselves in a scramble for capital goods. A sudden bunching of orders and expenditures for capital goods would add to inflationary pressures, lead to uneconomic investments, and might bring the expansion to a halt as imbalances of that sort have done in the past. Developments in the area of capital spending, especially the rise in appropriations, support the expectation that the second scenario -- a long expansion carried forward by investment spending -- will materialize. But it will take good sense on the part of business, and willingness on the part of government to encourage business capital spending, in order to stay on that track.

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