

For release on delivery
12:30 P.M., C.S.T.
April 12, 1984

Monetary Musings

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at the

Federal Reserve Bank of Dallas

Luncheon

Houston, Texas

April 12, 1984

I would like to talk with you today about our economic future. I am well aware, as a longtime user of economic forecasts, of the description of economic prediction as a mad dash through a maze of overlapping circles. The truth is that economic growth -- to the sometime discomfort of forecasters-- does take place through that maze of overlapping cause and effect, the new and the old, the foreseeable and the unforeseeable. Nevertheless, in spite of the overlap, I think it is useful for us to alleviate the confusion.

The environment for a high performance economy is shaped by the interdependencies of innovation, productivity, and economic policy. In thinking on our economic future, we need to analyze the lessons of recent experience -- of public sector policy and private sector developments. Which of those best indicate successful reactions to economic challenge? Which have the potential to contribute to high performance in the future?

The course of public policy provides one of the crucial elements for an economic period of continuing growth. At this juncture in the expansion, with recovery behind us, policymakers are faced with a basic dilemma not unusual in recent postwar economic experience. There is the objective, on one hand, to encourage further economic expansion, an expanding tax base, and the restoration for America's firms

of both domestic and international market shares. On the other hand, the apparent vigor of rising intentions in 1984 to put plant and equipment in place pose a real question for public policy of whether financing business investment, alongside unabating credit demands of consumers, mortgagors, and government will ignite boom-expectations and a market perspective and behavior leading to significantly higher rates of inflation.

There is a growing awareness that we have underinvested in the productive facilities of this country over the last few years. The "industrial policy" debate is illustrative of that perception. Indeed, the magnitude of the rebuilding task for industrial and service capabilities, plus public plant and infrastructure, is an enormous one. Research and development budgets, private and public, must be sustained to catch up on their inadequacy before the mid-1970s. An answer to the question of whether we have embarked upon a sustainable recovery, one of three or even four year duration, turns upon the durability and depth of business fixed investment and R&D spending in the private sector, and on the reconstructing of public infrastructure.

The issue in the minds of many forecasters today is how this transition from cyclical recovery to expansion will be maintained in the face of increasing nominal interest rates and the potential collision of federal mega-deficit

spending with steeply rising private credit demands. Some analysts have anticipated the emergence of a new business cycle pattern -- a repetition of the short succession of recessions of 1980-81. I disagree.

Without substantial economic growth, I do believe that long-term reinvestment and, to some extent, even near term business spending, can be seriously jeopardized by the consequences of our current gargantuan and unprecedented federal budget deficits, and more importantly, by the even larger deficits envisioned for the years to come. While the deficits have supported and strengthened demand for goods and services, federal government spending has drained off an extremely large portion of the available resources in the economy. Competition with private credit-fueled spending has kept real interest rates, however measured, much higher than in previous recoveries. We cannot afford to ignore the potential effects of short, shallow economic expansion and a weakened growth upon the tax base, and it is possible that excessively stimulative fiscal and monetary policy could lead the economy along an inflationary track of not one, but several quarters of, say, 7 percent real growth. Incentive and saving are harder to come by along that track of inflation.

It is not out of the question, however, that there could appear policy alternatives that would reconcile the

inequities of limited private credit availability and growth --that the economic reefs and shoals could be successfully navigated. Strong growth can conceivably surmount the regional and industrial sector imbalances of 1983's recovery. Indeed, when have we ever had an econometrically perfect balanced economy leading into expansion? Imbalances and underutilization of some industrial resources are inherent in the process Schumpeter identified as the "creative destruction" of industries and methods of production--an event central to innovation in a free-market economy. The key for economic policy is to provide the factors which will, on balance, encourage continued transition to a stronger, more resilient economy consistent with growth in employment and disinflation.

A key factor in determining the rate of inflation over the course of several cycles, has been the trend in productivity. Productivity growth had all but stopped in the late 1970s. After expanding 2.5 percent per year on average since World War II, output per hour for the nonfarm business sector grew at only a 0.7 percent rate for the years 1973 to 1980. However, we began to see its increase again during the last recession and it has risen rapidly during most of last year. Productivity in the nonfarm business sector grew by 3.1 percent in 1983.

Relatively good productivity growth is, of course, typical of the early stage of recovery. But both the quantitative and qualitative evidence suggests to me that more than cyclical forces are at work in important areas of the economy. Some analysts are forecasting continued advances in productivity averaging 2.5-3.0 percent yearly on into the 1990s.

Under the adversity of the last recession, with its heightened competitive and structural pressures, and in response to the diminishing expectations of speculative and inflationary gains, some management and labor alike have turned their efforts and their imagination toward ways to increase efficiency and curtail overhead. That, together with growing markets, accounts for the speed of the rebound in profits and in profit margins last year, even as prices remained stable. The cash flow of businesses has been further reinforced by the liberal treatment of depreciation and other tax changes enacted in recent years. After-tax economic profits relative to GNP, only a year after recession, are approaching the highest levels of the 1970s. These factors have contributed to a strong expansion in some types of investment during 1983 and 1984--particularly in the electronic equipment area which perhaps holds the greatest potential for efficiency gains in the services sector and carries with it a promise for future industrial productivity.

Between the years 1972 to 1983, investment in technology increased at an average rate of 13 percent, 2-1/2 times that of equipment spending as a whole.

John W. Kendrick, of George Washington University, one of the nation's foremost productivity students, was quoted in Business Week last month as believing that "...the U.S. is rapidly getting past the negatives that dragged down productivity in the 1970s." The unusual combination of food and fuel shocks that plagued this country in the past decade and produced widespread inflation in the U.S. and many other industrial nations, is, at least momentarily, behind us. Fuel cost increases, an adjustment process that initially caused a slowing of the economy and deterioration of productivity, have forced us to become more efficient. In the agricultural sector, the bottlenecks of the 1970s helped spawn an even greater commitment to new technologies and production techniques and led to over a 20 percent increase in that sector's productivity in the last ten years.

The problems of declining productivity, as well as the rise in unemployment, were exacerbated during the second half of the 1970s by a rapid expansion in labor force growth--the coming of age of the baby-boom generation and the increasing desire to work on the part of women. This rise in labor resources led to a shift in the ratio of capital and labor in the production process as the expansion of the labor

force far exceeded the growth of our capital stock. In the early 1980s, the growth in the labor force has slowed (to around 1.7 percent per year), and as our new work force has gained experience, its productivity should be further enhanced.

Business investment in plant and equipment, as a percent of GNP, remained constant during the adjustment period of the 1970s, but its resources, to a large extent, were spent in dealing with new safety, health, and environmental requirements and regulations. Much of that overhead has been successfully absorbed and the current political environment points toward a further reprieve from regulatory investment burdens.

Labor productivity has grown since mid-1982, after five years of stagnation, and there are signs that the trend in productivity may now be decidedly upward, despite the results of recent high-hiring months. Both management and labor have shown imagination and some willingness to control 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 utilization or deregulation have gone beyond concessions in wages and benefits to changes in work rules and prerogatives lying outside compensation. Nonunion labor has become more important in deregulated industries, and in construction.

A number of legal and institutional restraints have been changed to have a positive impact on the functioning of the economy. As an example, in 1978 Congress lowered the capital gains rates, thus stimulating venture capital expansion that bodes well for continued investment in new innovations and technologies.

In addition, as evidenced in the deregulation of the financial industry, there are other changes to our business structure that have been encouraged by increased competition and innovation, and that hold the promise of increasing efficiency and productivity. Of course, in the case of the deregulation of the financial industry, some of these changes have had the immediate impact of complicating the process of monetary policy and in the broader sense the implementation for public policy in the recovery period. The innovations occurring in the financial payments system and for savings instruments have also complicated economic forecasting. Econometric models, used by the Board and other forecasters, are based on past relationships among variables and changes in those relationships reduce the reliability of

forecasts. Old relationships may no longer be relevant, or the magnitude of mathematical relationships among variables may change. For example, interest rate fluctuations in recent years have been much greater than in the years on which most models are based.

Thus, in sorting through the opportunities before us in promoting a future of sustained economic growth and price stability, we must remain aware of the public policy goals that drive our free market economy. As with any business, the key to real growth in our economy lies in the fostering of increased productivity and innovation. Public policy must remain consistent with these goals as it works through the overlapping circles involved in the immediate economic opportunities before us. By judging whatever mechanisms are devised to deal with the immediate problems against these criteria, we can ensure ourselves that the future will be one of increasing prosperity and growth.