For release on delivery
12:00 Noon CDT (1 PM EDT)
May 10, 1984

Remarks by

Vice Chairman Preston Martin

Board of Governors of
the Federal Reserve System

at the

Kansas City Federal Reserve Bank Meeting

at

Tulsa, Oklahoma

May 10, 1984

I appreciate the opportunity to participate in your discussions of the outlook for business and the economy. My colleagues and I at the Board of Governors are fortunate to avail ourselves of the counsel from community leadership. The making of public policy benefits from econometric modelling and measures of broad aggregates but such analysis is incomplete without the immediacy of information directly from the business communities from whence innovation, productivity, and production are generated. Thus, debates on the budget deficit should not omit the benefits of a growing tax base encouraged by economic expansion. If the U.S. again attains the status of a high performance economy, growth would ameliorate the funding of massive spending commitments made at the federal level, though growth is not a complete solution.

The strength of the economic rebound from a recent recession-prone economic period demands a closer look at its wellsprings. The economy's strengths have been a surprise over and over again to that endangered species--the forecasters--bless their hearts. It has become more evident with each passing month of the recovery, that some of the old economic relationships don't hold in quite the degree they once did. Note the erratic behavior of the narrow monetary aggregate. Are there forces and factors behind the vigor of this expansion that suggest high performance? Or is the first seventeen months of expansion simply a prelude to reinflation? Think back to the reemployment experience of the last several months--around 4 million new job opportunities were created during the first year, and another 1.2 million new productive positions were added in the first 3 months of this year. Is this the route to full employment or a detour to cost-push inflation?

There are those who conclude that the economy is overheating, that there needs to be immediate action in both the fiscal and monetary policy areas--revenue enhancements and less accomodative monetary policy. There are those who argue that business fixed investment has come back too soon and too fast, and that business spending is colliding already with government and consumer demands for available resources, so that those resources must be rationed by the price system. Of course, there is no question that these risks exist. The question I raise is whether foreign competition, higher productivity, and present management and employee attitudes may have deferred reinflation.

These analyses leave open the questions: What would strongly rising business investment in equipment and plant really mean in terms of reinvesting in our society? What effect would this investment have on correcting the many years of underinvestment in our productive facilities and capabilities over this recent decade? I believe that there is no question of our need for economic growth. Our industries and services compete in an integrated world market. While the less-developed nations have built up their capacities, and as our European trading partners have rationalized their productive facilities a bit more, we have been busy consuming our capital. We have consumed the seed corn, so to speak.

As this is true for private investment--our industrial and services bases--it is also true for the public sector--the state and local infrastructure within which commerce functions. A period of sustained economic growth--one that could proceed without reigniting inflation--could be that sort of environment needed to restore and rebuild those areas of which we have underinvested for so long.

The benefits of reaching this objective, of course, are evident. The question remains, how to accomplish it. How can we reinvest in productive capacity and rebuild the infrastructure at a time when there exists a large and growing consumer demand for such basics as personal transportation and housing? How can we afford all of this simultaneously with federal mega-deficits, the magnitude of which boggle the mind? The answers will be heavily influenced by political considerations, but political decisions are facilitated by an environment of growth, the economic thrust of society.

But isn't there perfect correlation between nominal growth and inflation? If we are to be truly committed, as I believe we must be, to a policy of reasonable price stability, then economic growth must be accompanied by policies that can bring down the rate of inflation over time. That is, of course, the dilemma now facing economic policymakers. I am arguing that real growth cannot be simply taken for granted--disinflation should not be the sole and only goal of policy. And perhaps there are public policies now in place or that may come out of the political debate this year which can further encourage the rebuilding of our productive capacity. As an example, in 1978, Congress lowered the capital gains rates, thus stimulating a venture capital expansion that bodes well for continued investment in new innovations and technologies. In addition, the cash flow of businesses in this recovery has been reinforced by the liberal treatment of depreciation and other tax changes enacted in 1981 and 1982. After-tax economic profits relative to GNP, only a year after recession, are approaching the highest levels of the 1970s. This factor has contributed to the strongest investment expansion in some years during 1983 and

1984--particularly in the electronic technology area, which perhaps holds the greatest potential for efficiency gains in the services sector and carries with it a promise for future industrial productivity.

Though business investment in plant and equipment, as a percent of GNP, remained constant during the adjustment period of the 1970s, 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 to the opportunity for a reprieve from further regulatory investment burdens.

We should not be distracted from considering the further enhancement of productivity by our awareness that this expansion has been less than a perfectly balanced one. There are, of course, arguments of the negative effect of deficit financing on the growth of the more credit-sensitive sectors of our economy, or that an expansion can not be sustained in the face of burgeoning imports. Some industries, such as paper and aluminum, look as if they are at their capacity limits, whereas other sectors and regions seem to have responded only modestly to the recovery.

However, it is possible that we could conceivably avoid these economic shoals and reefs--that increased real growth and productivity could lead to augmentation of resources and of capacity suitable for utilization. Looking back, it is now apparent that the trend of productivity growth had all but stopped in the late 1970s. After rising 2.5 percent per year since World War II, productivity for the nonfarm business sector expanded at only a 0.7 percent rate in the years 1973 to 1980. However, we began to see its increase again during the last recession and it has risen more rapidly during most of last year. Productivity in the nonfarm business sector grew between 2.6 percent and 3.1 percent in 1983.

This sort of improvement is, of course, typical of the early stage of recovery. But the evidence--quantitative and anecdotal--suggests something more than cyclical forces may be at work in important areas of the economy. Some analysts are even forecasting continued advances in productivity averaging 2.5 to 3.0 percent yearly on into the 1990s.

Some economists are beginning to espouse the notion that the drop in productivity over the last decade has been largely a one-time phenomenon, contingent on a series of external factors, rather than a long-term trend toward less capital investment and innovation in the work place. The unusual combination of food and fuel shocks that plagued the industrial west in the decade past and produced widespread inflation in the U.S. and other industrial nations appear, at least temporarily, to be behind us.

Fuel cost increases forced our country to become more efficient--an adjustment process that led to a slowing of the economy and deterioration of productivity. Having taken a decade or so to work itself through, this adjustment is now largely completed, capable of returning positive benefits. The agricultural bottlenecks of the 1970s spawned a greater commitment to new technologies and production techniques and led to an increase in that sector's productivity of over 20 percent in the last 10 years. The agricultural sector could continue to be one of increased gains and economic growth in the future.

The problems of declining productivity, as well as the rise in unemployment, were also exacerbated during the second half of the 1970s by a rapid expansion of the labor force, caused by the coming of age of the baby boom generation and the increasing desire to work on the part of women. Some argue that 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 1970s. In the early 1980s, the labor force growth has slowed (to around 1.7 percent per year), at least for the United States, and as the new work force gains experience, their productivity may be enhanced.

In addition to the various external factors now changing to the positive, there is evidence that private sector initiatives promote productivity. One positive indicator of this is found in reports that business spending for research and development is on the increase.Both management and labor have shown imagination and some willingness to address productivity through new efficiencies in production. Two examples of lower overhead, and more flexible work rules and hiring practices--an aluminum plant expanded its output with one-third less work force; and ARMCO steel workers adjusted output to replace imported Swedish specialty steel. Elsewhere operators are doubling on the assembly line and the warehouse. Some managements have involved labor in locating new plants and where to expand existing ones, as well as in considerations of 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.

Sustainable economic growth and prosperity requires public economic policies having multiple objectives. Reinvestment of productive capacity and of infrastructure should enter national priorities. Admittedly, reinvestment is not a process that can be directly addressed by monetary policy. Certainly an "easy money" policy would carry the seeds of higher long term rates and less investment responsibility. Monetary policy can help sustain solid economic growth in the short run and move us closer to price stability over time, but it can't, by itself, ensure the positive environment for productivity, investment spending and incentives for productive and balanced growth.

To the extent, though, that monetary policy can build confidence in the outlook for more stable prices, it can promote a better expectational environment for declines in interest rates--nominal and real--over time. Lower interest rates are themselves elements in industry's "hurdle rates" of return on marginal investments. Their decline, in turn, would provide a powerful factor supporting and encouraging the business investment we need to maintain economic momentum and to support productivity growth.