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Economic Growth, Inflation and Profits:
Longer-term Perspectives

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Our experience in the past two decades tells us a great deal about the longer-term prospects for growth, profits and inflation. Growth and profits are inextricably linked to inflation. During the 1970s productivity and investment generally lagged behind long-established historic norms as inflation accelerated. Recently, there have been some encouraging developments. I will return to those later.

My message today is that the long-term prospects for growth and profits in our economy depend in a vital way on the environment for private decisions. An environment characterized by inflation and uncertainty regarding future inflation is likely to retard growth and profits. In an inflation-free environment, we can achieve maximum sustainable economic growth given our resources, technology and the other basic forces which contribute to, or constrain, our long-run potential.

The Importance of an Inflation-Free Environment

The role of economic policy, in general, is to provide an environment in which private individuals can make decisions that maximize long-term potential real growth and real profits. The contribution a central bank can make to this objective is to control inflation.

The proper role of monetary policy, therefore, is to maintain price stability over the long run. This requires a monetary policy with a perspective broader than the current business cycle. It requires a monetary policy with a clearly stated, consistently maintained objective of zero

inflation. I believe that specifying a path for reducing inflation from its recent level of about four percent to zero in some reasonable period -- three to five years -- would make a material contribution to reducing market uncertainty. By maintaining such a policy, we can provide the certainty and stability necessary to maximize our long-term potential growth.

The policy lesson from the 1970s is that an inflationary environment is not conducive to economic growth and corporate profitability. During the 1970s, we repeatedly shifted the focus of policy from fighting inflation to fighting unemployment. The result was that we achieved neither objective. Inflation trended upward and reached its highest peacetime level in 1979.

Inflationary expectations eroded the economic processes that generate long-term growth and became deeply entrenched in consumption, savings and investment decisions. The investment share of GNP declined. Demographic trends, such as the flood of new entrants into the labor force, also contributed to the resulting decline in productivity growth. Long-term potential growth in the United States, difficult though it may be to measure, slowed.

After a decade of policy failures, we learned that monetary policy cannot be counted on to smooth the business cycle. The adjustment process in the early 1980s was protracted and painful. This is not a lesson we should quickly forget. The lesson of the 1980s is that monetary policy can control inflation and, in doing so, can influence long-term real growth. ✓

We have reduced inflation substantially. But it seems to me that markets still lack assurance that low inflation can be counted on in the future. Consequently, it may be argued that the bulk of the gains from the difficult adjustments we made in the 1980s have not yet been realized. We are closer to

them, certainly. But, for example, long-term interest rates are high, relative to recent inflation rates. Furthermore, managements still seem reluctant to embark on longer-term expansion plans, if those plans entail significant longer-term commitments. I can only speculate, of course, but I believe that private decision makers need more assurance that inflation will not be allowed to accelerate beyond present rates and that we will indeed continue to seek and achieve an inflation-free environment within a reasonable time frame. Providing that assurance might substantially enhance long-term growth prospects.

Long-term Real Growth and Profits

This difficult adjustment to an environment of greater price stability has increased the credibility of monetary policy and has begun to pay some dividends in terms of long-term potential growth. I am optimistic about the outlook.

A salient feature of the current economic expansion has been the resurrection of productivity growth in U.S. manufacturing. Output per hour in manufacturing advanced at a rapid 3.3 percent pace in 1987. The 4.3 percent average since 1982 is the strongest five-year productivity boost in the post-war period. Productivity gains, along with the dollar's depreciation, have helped restore American competitiveness in world markets. This will surely enhance real economic growth and profits.

A surprisingly low rate of compensation growth in the manufacturing sector has complemented our gains in productivity. Indeed, unit labor costs in manufacturing fell last year for the fourth time in the past five years -- another post-war record. This, in turn, bodes well for our ability to achieve price stability if we choose to do so.

The trends in manufacturing are favorable, but we must not forget that the manufacturing sector employs an increasingly smaller portion of the work force. The shift of resources away from manufacturing towards the service sector seems likely to continue. The service sector, moreover, has not yet exhibited much improvement in productivity growth, although this may be partly a problem of measurement.

Nevertheless, I see grounds for believing that the long-term prospects for growth are favorable. The structural changes in the labor force which dampened productivity growth in the 1970s have reversed. The proportion of the work force in the older, more experienced age group is now rising. Labor force attitudes seem more consistent with the needs to increase productivity -- a development which may itself be the result of the less inflation-prone environment of the past five years.

Management also seems to have developed new attitudes. The internationalization of product markets has increased competition and forced management to intensify efforts to improve efficiency. As long as trade is free, these pressures will continue. Market discipline is also evident in financial markets. Capital moves freely, and with it, as we have seen, comes new methods, technologies, and added pressures to improve efficiency.

Deregulation, a growing appreciation of the need to improve efficiency, and the role of markets are increasingly important influences. Perhaps the most significant economic trend under way here and abroad is government recognition of the importance of markets and private decisionmaking for improving innovation and productivity. In economies as different as the United Kingdom and China there is a movement towards "privatization" and market allocation of resources. In the United States this trend is called

deregulation. Regardless of what it is called, strong private property rights are important to economic efficiency. This trend means private sector managers have more control over resource decisions and government less. Reducing government interference with private decisionmaking frees managers to use resources in accordance with the demands of the marketplace and encourages innovation and productivity.

If we want to compete in a global economy, it is important that we continue this trend in the United States. Other countries are moving aggressively to strengthen private property rights and market forces within their own economies.

Conclusion

At present, a number of developments bode well for the long-term outlook. Inflation has subsided, the dollar has depreciated, productivity has improved, attitudes and demographic trends are favorable. My view is that the basic forces which drive long-term productivity and growth are stronger today than at any time in the post-war period. The Federal Reserve can make a material contribution by stating clearly a long-term objective for monetary policy. By steadfastly pursuing that objective, the Federal Reserve can provide an environment that enables individuals and markets to make decisions that maximize the potential for long-term real economic growth and profits.