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The Economic Plateau

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An Address to the Annual Correspondents Conference,
Centerre Bank, St. Louis, Missouri,
April 30, 1987

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The American economy is on a high-level plateau and seems likely to remain there for some time. It reached that position in 1985, when the growth rate fell to 2.7 percent. We stayed on that plateau last year when real GNP grew at 2.5 percent. And it looks like 2 1/2 percent is also a good forecast for 1987 and, perhaps, for 1988.

The economic measure to watch is inflation. Technically, the overall inflation rate has been coming down steadily since 1981. But we all know that 1986's 2.6 percent rate was a fluke. It reflected a large one-time drop in oil prices. The inflation rate (as measured by the GNP deflator) this year is likely to exceed 3 percent. For 1988, it now seems that we will be lucky if inflation stays within 4 percent. Because the deflator only reflects domestic production costs, it is likely to register a little less inflation than the CPI, which also covers imports.

Thus, barring a pleasant surprise in the political or international arena, inflation is heading upward. The trend will be slow but steady, at least at first. I expect that serious inflation will occur as we come out of the next recession -- the one that has not yet shown up in my crystal ball. I mention that because policy makers in Washington will have to rely primarily on monetary stimulus to help pull the economy out of any future recession in the 1980s, given the huge budget deficits that are likely to accompany the start of the next downturn.

Monetary and Fiscal Policy

We always have to keep a watchful eye on the Fed. The Federal Reserve System has gotten the growth of the monetary aggregates down to where they seem to want them. M1 is currently in the target range, the first time all year. M2 and M3 are at or below the bottom end of their respective ranges. The Fed now has the flexibility that central bankers like to have.

Any really serious pressures for change in monetary policy are likely to come from overseas. The domestic economy is relatively balanced and growing modestly. Productive capacity in general is more than adequate. With excess capacity averaging 21 percent, the new tax law certainly is providing no stimulus to capital spending. The 1986 tax changes are a key factor in new housing construction plateauing at about a 1.7 million unit rate. The trade deficit is coming down. So is the budget deficit -- from $220 billion last year to about $180 billion this year and maybe $150 billion in 1988. Finally, consumer incomes and purchases are both slowing down. All in all, a so-so economy.

The strong downward pressure on the dollar in world markets obviously worries the Fed, especially the Chairman. Over the years, Paul Volcker has responded primarily to international financial pressures. Personally, I have no crisis scenario which would precipitate a huge shift in Fed policy. I believe that the decline to date still does not get the dollar back to the 1981 relationship. But the change does help our competitive position in world markets.

Clearly the large dollar depreciation is also a force for more inflation and higher interest rates. In part, this is a chicken-and-egg relationship. Higher U.S. interest rates help to stem the fall of the dollar. All in all, I see little expectation of much monetary ease unless the economy shows new and unexpected signs of weakness.

The recovery is in its fifth year. If we could compare the age of this recovery to human aging, it would be in its late 80s. That means that this venerable expansion is becoming ever more vulnerable to policy mistakes in Washington.

I do not see any big changes in fiscal policy that might threaten the recovery despite lots of sound and fury from both ends of Pennsylvania Avenue. Overriding the President's veto of the highway bill was not exactly a display of fiscal fortitude.

Trade policy is at a much trickier point. The best that we can hope for is a standoff between the White House and the Congress. Any action by either branch of the government is likely to be in the direction of more restrictions on imports. The politicians are all for fair trade, however. After all, isn't it only fair that they protect the consumer from the lower prices that result from more competition? On balance, I believe that the most dangerous foreign trade proposals -- those that could precipitate a trade war and potentially derail the recovery -- will be headed off.

The Debt Burden

I would like to take a few minutes to talk about a difficult and controversial subject, the rising levels of consumer, business, and government debt in the United States. Of course, I am not defending the doubling of the federal debt since 1980. That is an undesirable development. However, my main objection is that the money was used to finance current consumption -- transfer payments, farm subsidies, and so forth. If the money had been used for investment purpose, we'd all be better off.

In that spirit, when I turn to the rapid increases in business and consumer debt, I do not find the recent trend worrisome. On the surface, the equity base available to support business debt appears to be shrinking. The recent wave of mergers -- and the efforts of management to deter takeovers -- has resulted in large amounts of corporate stock being retired and often replaced by new debt. In 1985, the excess of stock retirements over new shares was over $80 billion -- a situation without historical precedence.

This development may not be as serious as it appears, however. The "de-equitization" has been more than offset by the large amounts of after-tax corporate profits that American corporations as a whole have been plowing back into investment in plant and equipment. Even after providing for the replacement of capital consumed in production (i.e., depreciation), $250 billion of "economic" profits were retained by nonfinancial businesses in the United States in 1985.

How heavy, then, has the expanded debt load of American business become in comparison with the total ability to carry it? One basic measure, the debt/equity ratio, shows a significant rise -- from about 0.7 in the early 1970s to more than 1.0 at present. When the data are converted from book to current market values, however, the ratio of debt to equity remains well below the peak of 1.3 reached in the middle 1970s.

Perhaps the most relevant measure from the viewpoint of economic analysis is the relationship between corporate indebtedness and the productive assets which it finances. Technically, that means comparing the total rise in debt with the increase in the net long-term investment plus working capital over the same period.

In every single year over the last decade, the increase in physical assets has been larger than the rise in corporate indebtedness. In other words, there seems to be real value behind the rising debt load of American business. The very same point can be made about consumer debt. Consumer assets have been rising faster than consumer indebtedness. There is little basis for saying that consumers in general are overextended. At the beginning of this year, 12 percent of consumer disposal income was required to service debt. This compared to 13 percent in 1979 and a fraction higher during peak periods in the early 1970s.

Not all analysts and participants in financial markets are sanguine on this issue, however. The rising indebtedness of U.S. business has been accompanied by substantial downgrading of corporate debt. It is also interesting to note that prior to 1970 the big swings in business and government debt tended to offset each other. In the last several years, however, both public and private borrowing has been rising faster than the economy as a whole, driving the debt-to-GNP ratio to a new high.

Yet, all in all, we can conclude that the aggregate debt burden of the U.S. is still manageable because of the asset buildup that it has financed. Nevertheless, positive macro developments are no substitute for the continuing need for each company to watch its own balance sheet carefully.

The Longer-Term Outlook

But I want to end on an upbeat note. Taxes and deficits are important, but they are not the main show in the American economy. Because we are primarily a private enterprise society, the basic economic decisions are made in the private sector. And here the fundamentals are positive.

I see a more productive and competitive economy emerging in the decade ahead. My optimism is not simply the result of excessive exposure to radiation from my crystal ball. The fact is that the industrial sector of the American economy is in far better shape than we read about. Sometimes there seems to be a journalistic version of Gresham's Law -- bad news drives out good.

I will let you in on one of the best kept secrets in the economy. American manufacturing is not becoming "hollowed out" nor is it being relegated to marketing the products produced by foreign firms. Industrial production in the United States today -- in real physical volume terms -- is at the highest point in

American history, almost 27 percent above the 1977 level and that is a nice improvement over last year, when industrial production reached 26 percent above the 1977 base.

So much for the cries that U.S. manufacturing is going down the tube or the loudly trumpeted demise of our industrial base. Gloom and doom predictions make great headline material, but they are just plain wrong. Manufacturing's share of the GNP has held steady -- at about 23 percent -- for the last 30 years.

In our research at the Center for the Study of American Business, we have identified three key positive forces at work which make it likely that American industry in the coming decade will be more productive and hence more competitive.

The first is the cost-cutting underway in most industries. Spurred by foreign competition as well as takeover threats, management and labor in company after company are finally facing the challenge by controlling expenses, improving productivity, and ultimately restructuring the enterprise.

Second, and also pushed by the twin threat of imports and restructuring, more employees are taking personal responsibility for the quality of their work. Far less frequently is shoddy workmanship merely accepted, with the hope that the quality control inspector will catch it. Doing it right the first time is really the most cost-effective approach. Quality work is also a better guarantor of job security than most formal union agreements.

Finally, it has become fashionable to bemoan the short-term orientation of American business, and especially its unwillingness to invest sufficiently in such long-term activities as research and development. But the truth is we are witnessing an unprecedented large business commitment to research and development. The number of Ph.D. scientists and engineers in American industry rose from 344,000 in 1981 to over 400,000 in 1985. In the past decade, industry spending on R & D has risen by an average of 5.3 percent a year. The Battelle Research Institute is forecasting a 7.2 percent rise for 1987.

For the 1980s to date, the private sector has become the number one source of new money for science and technology, with the federal government in second place. That shift from federal dominance in the 1970s means that most R & D projects are now oriented to commercial needs.

On balance, a positive assessment is in order for the American economy. This upbeat conclusion relies on the powerful importance of feedback effects. During the rough times experienced by many companies in recent years, by and large they have been making the tough decisions that keep costs down and productivity up.

The near-term outlook for the American economy lacks any oomph. But that sure beats the recession that many forecasters had expected by now. Although the immediate effect is painful, competition at home and abroad is forcing American business and labor to take the necessary actions that will make for a stronger economy in the 1990s. That underscores a far more basic point -- in this changing environment there is both threat and opportunity.