For release on delivery
4:00P.M. E.S.T.
February 24, 987

Remarks by

Wayne D. Angell

Board of Governors of the Federal Reserve System

before the

National Association of Business Economists Policy Forum

February 24, 1987

I am pleased to be here at this forum on public policy sponsored by the National Association of Business Economists. My remarks will focus on the considerable challenges facing the conduct of monetary policy, with particular emphasis on what I believe to be the critical objective of the Federal Reserve -- the achievement of overall price stability. In that effort, I hope to draw some lessons from the past and to suggest how these lessons could perhaps be used to shape our response to some of the prospective influences on monetary policy in the near future.

The performance of inflation over the past year has been extremely encouraging. Consumer prices rose a bit more than 1 percent -- the smallest increase since 1961 -- and producer prices fell 2-1/2 percent. To be sure, the extraordinary performance of inflation last year reflected, in part, the transitory influence of the sharp drop in world oil prices that occurred early in the year. Nevertheless, there were indications of wider and more fundamental progress. The overall cost environment in which businesses operate showed further improvement. Outside of oil, prices for many raw materials and manufactured inputs declined throughout much of the year, pushed down by the increase of worldwide productive capacity and continued sluggish growth in demand in the major industrial economies. In addition, nominal wage growth accelerated its downtrend, reflecting the persistent competitive pressures of an increasingly global economy. It has been particularly heartening to achieve further progress toward price stability even as the economy has entered the fifth year of cyclical expansion -- making it one of the longest of the postwar period.

The recent successes are perhaps all the more significant coming, as they did, on the heels of the longest sustained period of inflation in our nation's history. It was just a few years ago that the problems engendered by high and chronic inflation occupied the center stage of economic policy considerations. The inflation of the late 1970s and early 1980s had destructive effects on our major political and economic institutions, which were ill-equipped to adapt to the rapidly changing environment. It also had demoralizing effects on the country as a whole, as the result of heightened uncertainties and capricious redistributions of income and wealth -- effects which sapped incentives for truly productive endeavors and which rewarded efforts to "beat" inflation.

Many thought chronic inflation was a problem that would persist far into the future and which the central bank arm of the government could not or would not bring under control. Indeed, even as the present recovery began, and despite the substantial progress that had been attained, it was a common expectation that a new cycle of inflation would commence. Now into the fifth year of the current economic expansion that attitude has at least been called into question.

But rather than congratulating ourselves on past accomplishments, I would rather have us remain alert to the challenges ahead and some of the dangers we are likely to encounter. Although there are signs that the outlook for the federal budget deficit has improved, many difficult budgetary decisions still lie ahead. Moreover, our trade imbalance reflects severe strains on certain sectors of our economy -- most notably, manufacturing and agriculture. Beginning along a path that leads to some resolution of these imbalances will certainly carry longer-term benefits for the economy, both in terms of the strength and the longevity of our current expansion. However, the adjustments that will be required of the economy in this period of transition also create potential hazards for policymakers.

In this respect, I believe that some important lessons can be learned from the inflation experience of the past two decades -- lessons that might help us avert the creation of a new cycle of inflation, with all the accompanying difficulties. One observation is that the beginning of this period of accelerating prices, the mid 1960s, had its origins in the failure of the Federal Reserve to counter the worldwide abundance of dollars distributed by the simultaneous spending on the Vietnam war and the expansion of outlays for domestic programs. Moreover, the initial round of price increases supported the notion of a world with finite resources confronted with a geometrically expanding population. With world resources seemingly fixed, the price increases appeared to be permanent.

A second observation surrounds the effects of sharp changes in relative prices of commodities -- most notably food and oil, but also for a wide array of other raw commodities -- and the response of macroeconomic policy. Although inflation had risen steadily from the mid 1960s, it gathered momentum following the run up in commodity prices in 1973 and 1974. It remains difficult to sort out completely the directions of causation, but I think that it is safe to say that once commodity prices provided impetus to the inflation spiral, it became a self-perpetuating process. The upward pressures on business costs soon found their way into prices and eventually into wage demands.

Faced with the painful tradeoff between some decline in output and an increase in the price level, there was a tendency in the conduct of macroeconomic policy to allow an upward ratcheting of the price level in response to these disturbances. But a series of short-run decisions to "accomodate" these inflationary pressures further raised expectations of inflation. Moreover, the macroeconomic influences on prices were compounded by a myriad of microeconomic regulations that raised costs and often hampered the natural adjustment responses of the market. Price ceilings on oil and natural gas were particularly significant in altering the supply side and conservation responses.

The general environment fostered private behaviors that were predicated on existence of persistent inflation and the acquiescence of economic policy to that inflation. People shifted portfolios toward perceived hedges against inflation and away from nominal financial assets, which only reinforced the basic cycle of inflation. While the demand for financial assets, including money, was waning, Federal Reserve policy supplied more money than the public chose to hold. By the late 1970s expectations of inflation were firmly entrenched and an attitude existed that policy was virtually impotent to bring the situation under control.

The more recent story is, of course, quite familiar to all of you. Although the inflation threat has not been eliminated, it has been systematically reduced. Of course, the cost has been very high. First, deflation was necessary to demonstrate that prices can come down, as well as go up -- certainly not an attitude that was prevalent under persistent inflation. I think this is, perhaps, the most critical lesson to be learned from this episode. Monetary policy must remain aimed toward the objective of stabilizing prices by managing the scarcity of money. If temporary shocks are allowed to permanently raise the general price level, we run the considerable risk that expectations of inflation will reemerge in the attitudes and behaviors of the private sector. As we have seen, reversing these attitudes can be terribly costly.

In offering these observations, I do not wish to minimize the enormous difficulties faced by those individuals who had to make policy under these trying circumstances -- indeed, some of these problems were being faced for the first time. But I believe that it would be a mistake not to try to learn from these experiences.

Our current situation offers us an opportunity with great potential but not without some perilous obstacles. Inflation is lower now than it was in the mid 1960s, when the previous cycle of inflation started. Although expectations of inflation remain distressingly high, there has been further improvement over the past year and this has been reflected in the trend of moderation in nominal wage gains. It is to be hoped that the Congress will not reverse this trend by returning to a policy of increasing minimum wages. With respect to fiscal policy, the Gramm-Rudman-Hollings targets have at least provided a framework for signaling the intention of Congress to face many of the difficult decisions that will have to be made to achieve significant reductions in our federal deficit. I also believe that there is a growing realization that our central bank remains committed to the stabilization of the general level of prices.

Nevertheless, we face considerable risks in 1987. On the one hand, the performance of the global economy has remained decidedly lackluster. Any weakening in the major industrial economies could rekindle the deflationary forces witnessed in 1986. On the other hand, the effect of falling oil prices will no longer be offseting increases in import prices resulting from the dollar depreciation. Whereas in 1986 the dollar was appreciating against commodities while depreciating against competing currencies, in 1987 we run the risk of further dollar depreciation leading to prolonged increases in commodity prices.

In this respect, it is time to be on guard against further dollar depreciation. Thus far, many foreigners that export goods to the United States, as well as domestic distributors of these goods, have been willing to pare profit margins that had expanded during the period of the appreciation of the dollar, rather than raise prices and suffer reduced market share. As a result, the rise in import prices has been subdued relative to what many had expected. Nonetheless, the decline in the exchange value of the dollar -- particularly should it proceed much further -- poses potentially important risks to the price environment. I would add that these risks will be compounded by any movement toward protectionism.

I believe that we can surmount these obstacles with a minimum amount of economic disruption by keeping monetary policy oriented firmly to bringing down the rate of inflation. In this way, some of the pitfalls that befell policy in the previous cycle of inflation could be avoided. After all, central bank credibility is a fragile attitude -- it is much easier to lose than to regain. With that in mind, we must make an effort to prevent a series of transitory adjustments of relative prices from becoming embedded in expectations of future inflation, thus initiating a new cycle of price inflation.

In view of both the opportunities and risks, the year ahead is likely to be a critical one. The actual course of monetary policy will be influenced, as it was in 1986, by the way in which the major uncertainties facing us are resolved. A significant weakening of economic activity signaled by a reemergence of deflationary trends in the world economy would likely call for a more accommodative stance in policy. In contrast, should temporary increases in import and oil prices display any tendency to spill over into a wider range of prices, or for that matter wages, a less accommodative policy might be in order. In any event, I believe the overriding consideration for monetary policy in 1987 must be to demonstrate a commitment to follow a program consistent with appropriate dollar scarcity relative to world traded commodities.

Steering the proper course for monetary policy recently has been more complicated than usual. The monetary aggregates, when viewed in isolation, have become less reliable indicators of the thrust of monetary policy. The recent relationship between money, activity, and prices has moved closer to the historical experience between 1921 and World War II than to the postwar period. The unprecedented declines in the velocity of M1, the narrowest aggregate, have taken place against the backdrop of major innovation in our financial system, associated with deregulation, and substantial adjustments in financial portfolios. In large measure, these portfolio adjustments reflect the responses to the dramatic change that has occurred in the inflation and interest rate environment.

For these reasons, I believe that monetary policy will have to be guided by a broader range of economic and financial indicators. In this respect, it seems to me that the information generated by so-called "auction" markets can be valuable in this effort. The timeliness with which the participants in these markets process information and reflect emerging trends in prices and activity make these markets worthy of attention. I think commodity prices, in particular, have yielded important readings on industrial activity and the accompanying pressures on prices. The declines in commodity prices that occurred in 1985 and early 1986 were signaling, at least in part, the latent weakness in the economies of the major industrial nations. The subsequent policy actions we took appear to have helped break that disturbing trend.

I would, however, be reluctant to disregard the information provided in other auction markets -- most notably the markets for foreign exchange and corporate equities. In that regard, declines in the value of the dollar such as we have witnessed recently would not be compatible with the goal of price stability if they were to continue. Meanwhile, equity prices reflect the present value of expected cash flows discounted at the expected rate of interest. It is only natural that equity prices would rise as disinflation lowers the expected rate of interest. Although the pieces of the puzzle are likely to be incomplete and at times contradictory, I believe that these auction markets, taken together, can be important aids in gauging the appropriate stance for monetary policy.

But monetary policy alone is not able to ensure that our economy can continue to make progress toward price stability, while achieving steady and broad-based growth. Other actions will reduce greatly the burdens and risks faced during the process of adjustment to a better balance in our internal and external accounts. As I mentioned earlier, it is imperative to make sustained progress toward reducing the federal budget deficit. By reducing the deficit, market interest rates decline, ensuring adequate private capital formation, without reliance on capital inflow from abroad. Without the high return in the U. S. capital market, trade surplus countries would be more inclined to find an outlet for their trade surplus dollars in the third world.

Complementary domestic policy actions by the major surplus countries also would help reduce the risks to the global economy. Our external imbalances here have counterparts among our trading partners. Relying primarily on exchange rates to bring about these necessary adjustments only heightens the probable pressures on prices. Faster economic growth in the surplus countries offers an alternative way to raise the demand for goods and services produced in the United States, reducing both our deficit and their surpluses. Moreover, more rapid growth in the industrialized nations would ease the debt problems facing many developing countries and would consequently alleviate some of the accompanying strains on our international financial system -- an outcome in which we all share a common interest.

To date, there are few encouraging signs of a pickup in economic activity abroad. Although some adjustments to policy have been made, I would think there is scope for further action on the part of the major surplus countries, in particular Japan and Germany. The reduction in Japan's discount rate last Friday is a welcome step in that direction. It would seem in the self-interest of these countries to ensure that domestic demands are expanded to take up the slack that will be left by diminishing foreign outlets for their goods resulting from the appreciation of their currencies. Disciplined and complementary policies by the leading industrial nations should reduce our collective burdens during the transition to a more balanced and noninflationary global economy.

One course of action that would surely inhibit continued progress toward a noninflationary world would be to yield to pressures for greater protectionism. These pressures are understandable given the considerable strains that have persisted for quite some time now in our tradeable goods sector. But given the inevitable retaliatory response of our trading partners, protectionist actions would do little to aid our overall position in international trade. These actions would, however, raise prices needlessly. Much as the regulatory environment of the 1970s raised business costs, protectionism would lead to the type of self-inflicted wounds that make achieving price stability that much more painful. Moreover, the costs of protectionism are not just economic, but are political as well. Protectionism is a process that once started is difficult to stop, let alone reverse.

On the whole, I remain optimistic that we can take the constructive steps necessary to create an environment in which progress can be made toward price stability, while maintaining some forward momentum of economic activity. Some temporary uptick in measured inflation seems likely in 1987 given the recent rebound in oil prices and the upward pressures arising from higher import prices. But if oil prices and the exchange value of the dollar were to stabilize around current levels, it would not seem excessively optimistic to expect a temporary uptick in consumer price inflation to about 3 percent over the year and then in subsequent years.

Nevertheless, the precise numerical outcome of the statistics is, in some sense, less important to me than the prevailing attitudes and expectations about inflation. I believe the historical record suggests the critical importance of preventing a series of one-time shocks from permanently raising inflation. If we are viewed as being complacent with a permanent rise in inflation, the effect on expectations would be damaging and, in the end, would only raise the costs of moving toward overall price stability at some point in the future. Only by concentrating our efforts on achieving price stability can we foster the greatest possibilities for further expansion of activity with maximum productivity. In doing so, we will lay a foundation for noninflationary growth that will be capable of supporting lasting advances in the well-being of our nation.