Economic Policy Issues for 1988 and Beyond

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I am honored to have this opportunity to address the annual meeting of Greater Cleveland Growth Association. In the few short months that I have been in Cleveland, the one thing that has impressed me most is the enthusiasm the business community has for this city and the commitment you have to its continued development.

My message today will focus on the uncertainty that economic policies around the world are creating in financial markets. I will discuss the role of markets in shaping economic policies, the large increase in uncertainty evident in financial markets in recent months, and how, in my view, policymakers can alleviate some of that uncertainty. Although these are national and international economic issues, they are extremely important to Cleveland's future.

The Reemergence of a Competitive Manufacturing Sector

The 1980s have been especially difficult years for Cleveland and other industrial areas of the country. We have experienced an enormous transformation in our economies. Once-prominent industries have declined in absolute and relative importance. Under the pressures of competition, firms have been forced to alter operations and restructure facilities. Change of this sort is usually painful for the people and the communities involved, but if change is inevitable and leads to a better world, then much has been accomplished.

Here in Northeast Ohio, the results of change are emerging, and two observations can be made concerning the future of our economy. First, the manufacturing sector will continue to be important, but will employ a smaller proportion of the labor force. Second, the service sector will continue to grow, as measured both by employment and output.

The service sector's dramatic rise has not meant the deindustrialization of our region or the country, any more than the massive shift of employment from agriculture to industry at the turn of the century led to a loss of output in agriculture. Manufacturing will continue to be a basic component of our economy and the nation's economy. In fact, it still claims roughly the same percentage of GNP that it did after World War II--a share which may well rise somewhat in the next several years as we close the trade deficit--even though its employment share has declined sharply.

The year 1987 has been heralded as the "Year of Manufacturing." Nationally, manufacturing output in 1987 rose by 5.7 percent over 1986, and manufacturing employment also rebounded. Last year, over 300,000 factory jobs were added, an increase of 1.6 percent. Although the increase last year was the largest since the early part of this expansion, it comprises only 11 percent of the 2.8 million jobs created between October 1986 and October 1987. The service sector, which claims 24 percent of the economy's jobs, generated 1,045,00 jobs, or 37 percent of the total new jobs, over the same period.

These statistics tell us that manufacturing output continues to expand, but with fewer workers. The general shakeout in manufacturing experienced over the last 8 years has resulted in a leaner, more competitive manufacturing sector. Productivity in the manufacturing sector has been rising at a rate of 3.5 percent per year since 1980--twice the rate of growth of productivity in the total business sector. Industries have made conscious efforts to modernize their facilities. According to recent surveys, new plant investment is being targeted more toward modernization than toward expansion.

We expect the structural change that has been underway in our local economy to continue. In order to see continued positive results from this restructuring, we will have to see continued improvement in the productivity of our manufacturing sector and of our service sector. We are after all going to be forced to compete with other regions and countries in export markets for services. This can be accomplished only in a stable economic environment. An environment of stable prices and stable taxes. We have to remove the uncertainties that are created by high and varying rates of inflation, and consequently, high interest rates. In a stable economic environment, industries can make long-term investments in plant and equipment which will contribute to further increases in productivity.

We have made much progress towards a noninflationary, more market-driven economy, but we are not there yet. As the turbulence in financial markets of the past several months so clearly indicates, some people doubt that we will conclude the voyage successfully. To get back on track, I believe economic policymakers here and abroad should focus again on long-term objectives. We should specify the objectives and announce them publicly. We should make the objectives clear, and we should assign priorities to them. These steps will strengthen the commitment of policymakers to achieve the objectives, and if policymakers take actions to achieve their stated objectives, they will strengthen the credibility of policy.

Sources of Uncertainty in Financial Markets

Of course some degree of uncertainty is inherent in financial markets, but I believe the developments of recent months are symptomatic of a deeper underlying problem--a problem which I might characterize as growing uncertainty about economic policy, including the market's inability to perceive a commitment by economic policymakers to achieve a non-inflationary environment. After all, consumer prices did rise last year by 4 percent.

It seems to me that there are several major sources of uncertainty about economic policies. It is also obvious that many uncertainties cannot be removed or even alleviated without resolving several fundamental issues--issues which have been long debated but remain unresolved.

At the top of any list is the federal budget issue. Simply put, how large should government be and how will the services we demand of our government be paid for? It may well be that in some technical or theoretical sense the budget issue is not the root of some of our problems. Perhaps the Federal Reserve, for example, can be counted on to achieve and maintain price stability regardless of the budget deficit. In an environment where government becomes larger, as it has, and government services are paid for with debt issue, as they have been, some market participants may suspect that pressures on the Federal Reserve to inflate the economy will mount. The Federal Reserve has resisted such pressures over the past eight years of disinflation. Eventually, however, failure to resolve the budget issues could cause some market participants to believe that either a weakened resolve by the central bank or an erosion of its independence will occur.

Protracted debate and discussion over the budget has produced neither meaningful action towards change nor assurance that change is on the way. From the vantage point of financial markets, the issue has assumed even greater importance, to the point of affecting the pricing of the entire range of domestic and international financial assets.

From fiscal years 1984 to 1986, federal debt in the hands of the public grew at about 15 percent annually--about twice as fast as national income. The growth of federal debt slowed last year to about 10 percent, but this reflected only a temporary bulge in tax revenues. The protracted budget impasse late last year demonstrated that there is still no apparent consensus about how to slow the growth of federal debt. Failure to agree on how to slow it means that there is still great doubt about whether it will be slowed. And this uncertainty is reflected in the increased volatility and higher risk premiums in financial markets.

A second issue contributing to uncertainty centers around the exchange rate, trade policy, and our trade imbalance. Early in this decade, we reached a workable consensus that the value of the dollar was a matter best left to the markets. We recognized that we did not know what the equilibrium exchange rate was and, mindful of the damage done in the 1970s with inappropriate exchange rates, we also recognized that policies designed to maintain an inappropriate exchange rate were detrimental to our domestic economy.

To meaningfully influence exchange rates, policymakers have to make fundamental changes in monetary and fiscal policies. Surely we are moving toward a more global economy. Nevertheless, nations still tend to do what they perceive to be in their own best interest, regardless of prior commitments made in international agreements. The political process through which countries define and implement their self-interest virtually guarantees that policies will seek mixture of short- and long-term interests. These interests will change more in accord with domestic short-term political desires in each country than with the longer-term demands of a truly global economy. Consequently, market participants are forced to make judgements on a wide range of issues that have very uncertain outcomes.

An equally important issue is the protracted debate over trade policy. Following World War II, governments reached consensus and made basic commitments to achieve expanded trade and open borders. Over the intervening four decades, progress was spectacular, but our resolve to continue down this path seems to have weakened in recent years as a result of the disinflation strains and steadily growing competition from foreign producers. Strong pressures for protectionist legislation in the U.S. reflect the sensitivity of management and labor to the inroads of foreign competition. Fortunately, our trade position began to improve in late 1986 as foreign exchange rates began to correct, and this trade correction is expected to gather steam in 1988. However, protectionist legislation could threaten continued progress. Closing ourselves off from foreign markets would produce significant adverse impacts in capital markets as well. While financial markets cannot keep governments from taking protectionist actions, they can and will reflect the follies of such actions by marking down prices of those governments' securities.

A third major source of uncertainty involves monetary policy. Our central bank operates with a mandate that is neither clear nor consistent. Compounding the problem in recent years, at least, is the weakened link between the money supply and spending. This weakened link has greatly diminished the usefulness of a money growth rule of thumb to guide policy judgement and to communicate policy objectives to the public. Determining whether policy is actually compatible with those objectives has also become more difficult. The weakened link between money and spending has forced the Federal Reserve even more explicitly into a judgemental policy unrelated to any single measure of money or other financial or nonfinancial measure. Generally speaking, the Federal Reserve has exercised its judgement pretty well over the past several years. While I believe monetary policymakers have done a good job, the methods we have been forced to use have obscured our ultimate objectives so that markets cannot tell whether our policies are compatible with a non-inflationary outcome.

Lacking a rule of thumb for monetary policy has added greatly and unavoidably to uncertainty even about near-term prospects for business activity and inflation. In fact, some, including myself, are concerned that the recent slowdown in money supply growth, unless reversed, may result in a weaker economy in 1988 than is now commonly expected. Others see more strength in business activity this year than I do and believe that policy based on judgement, in an election year, is likely to mean even more inflation.

A similar uncertainty prevails abroad where economic growth has been sluggish. Keeping inflation low has received a high priority, but in recent months money growth has accelerated beyond target ranges in Germany and Japan. As their currencies appreciate, their export growth is threatened. Whether policies abroad will be driven by concern for future inflation or by concerns for sluggish economies and a rising exchange rate continues to be a source of considerable uncertainty.

I suggest that the relative calm of 1986, and much of 1987, rested on a monetary policy stance which was a reasoned accommodation to the situation and the underlying uncertainties. But, it seems to me recent events suggest a substantial increase in market uncertainy about the ultimate outcome. The fundamental political and economic issues remain unresolved and the markets question whether those issues will be resolved in a manner compatible with noniflationary economic growth.

General Policy Principles

Today, financial markets hold the attention of policymakers around the world. The October 19 crash reemphasized the reality that markets serve as a constraining force on economic policy choices. Ultimately, policymakers have little choice but to reexamine policies and attempt to alleviate some uncertainties. As policymakers reexamine policies, I recommend that they keep in mind two old principles. One is simply that a government's ability to issue debt is constrained by the willingness of the public to buy its debt. The other is that inflation is a problem not a solution.

The government can run deficits, but the government cannot, indeed will not be allowed to, ignore the constraint placed on its ability to float debt by the willingness of markets to purchase that debt. Markets will reprice financial assets and recognize accordingly the underlying economic reality. The ongoing federal budget discussion may be too narrowly focused on the deficit, but my point here is to suggest that the issue is simply that federal debt may be growing rapidly enough that the public, both here and abroad, increasingly may show greater reluctance to buy it. I suspect this would be less worrisome to markets if the government showed greater determination to reduce the growth of federal debt, or if the U.S. economy were less close to a condition of full employment.

The second principle is as familiar as the first: inflation is a problem, not a solution. While this principle may seem so obvious that it does not merit mention, it is a principle that continues to be challenged. In a recently released book about the Federal Reserve (Secrets of the Temple: How the Federal Reserve Runs the Country, by William Greider), the author advocates reinflating the economy to stimulate economic growth. According to the author, "The resumption of inflation would mean rising shares for wage earners...would restore overburdened debtors to solvency...would begin to discreetly redistribute wealth in a positive direction."

The lessons of the 1970s seem clear to me. We cannot achieve a stable economic expansion in an inflationary setting. In a world of floating exchange rates, it can be difficult to know in the short-run whether a nation's policies are too loose, for example, or too tight. The inflation principle provides good guidance. West Germany and Japan have inflation rates that are close to zero, while the U.S. inflation rate is around 4 percent and some fear that it will be moving up. The presumption should be that it is the United States that should be aiming at lower inflation. Our inflation rate is the one that should be declining toward convergence with theirs, rather than theirs rising toward convergence with ours. While that is the responsibility of the Federal Reserve, the matter is not as simple as it appears. One can, and indeed markets do, question whether the Federal Reserve can or will be allowed to proceed toward an inflation-free environment.

I am convinced that policy decision-making based on these two old principles would reduce both exchange rate volatility and pressures for protectionist legislation. Volatility and the attempt to change market outcomes by legislation reflect uncertainty about macroeconomic policy.

Inflation rate uncertainty becomes interest rate uncertainty and exchange rate volatility. Exchange rate volatility gets reflected in legislation to protect industries from uncertainty about exchange rates.

Setting and Stating Monetary Policy Objectives

Clarifying objectives and obtaining support for pursuing them should be the order of the day for policymakers. Stating goals and setting priorities for the monetary policy process would be a very useful step. It would promote discussion of these goals and assist in the formulation of a broader consensus on the primary responsibility of monetary policy. It might also clarify the goals that monetary policy cannot achieve, except at the cost of the primary inflation goal. Of course, once goals are stated explicitly, we must take actions to achieve them. Only through effective actions will policymakers restore their credibility with financial markets.

I believe that a more forthcoming statement of monetary policy objectives can make a material contribution to reducing market uncertainty. Obviously, it is not the complete answer. The uncertainty from the federal budget and protectionism issues are beyond the reach of the monetary authorities. But we can help reduce uncertainty by making an inflation-free environment our primary goal, and also by specifying a time path, perhaps 3 to 5 years, over which we will achieve it. By making zero inflation the overriding priority, lesser objectives will be assigned a lower priority and will assume a less prominent part in the formation of market expectations. We might also reduce confusion and uncertainty by specifying some of the things we are not trying to do. For example, we might indicate that beyond providing an inflation-free environment, which is conducive to economic growth, we do not intend to smooth the business cycle or affect the exchange rate.

This is a long-run view, of course. But unless we lift our eyes from the problems of the day, we have little assurance that conditions will improve in the long run. At the moment, the monetary policy impact on and response to short-run market conditions is foremost in our thoughts, but the underlying problems will reemerge. Markets will not allow us to forget these problems. They are assessing daily the likely course of economic policy in 1988 and beyond.