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Remarks by

Wayne D. Angell

Member, Board of Governors of the Federal Reserve System

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I am pleased to be here at the University Club of Chicago. My remarks will focus on the current economic situation and the priorities for monetary policy in 1987--what I believe are likely to be the key influences on Federal Reserve decisions and how the policy environment is likely to differ from that of 1986.

The past year has been marked by some significant successes. Inflation in 1986 reached its lowest level in many years. The increase in consumer prices of around 1-1/2 percent was the smallest since the 1960s, while producer prices actually declined 2-1/2 percent. The dramatic drop in world oil prices clearly played an important role in the favorable price performance, but was not the only factor. Prices of other industrial materials continued to decline through much of the year, depressed by abundant world supplies of many primary commodities, by the efforts of many developing countries to maintain or expand their output in order to meet debt-servicing obligations, and by the sluggishness of industrial activity in the United States and other large economies. In addition, wages continued to adjust to competitive economic fundamentals consistent with a noninflationary environment. Wage growth in the United States, averaging 2 to 3 percent last year, was among the lowest in the industrialized world.

Economic activity continued to expand at the moderate pace that has been evident, on average, since mid-1984. Although household spending responded vigorously to the lower energy prices and interest rates, conditions in a number of key sectors and regions of the country were depressed. In particular, manufacturing output remained sluggish in the face of intense competition from foreign producers, given the lingering effects of the earlier high foreign exchange value of the dollar, and the paucity of export opportunities in slowly growing markets abroad. In addition, domestic oil exploration and investment was cut back sharply, driving energy-producing states into recession and dampening demand for capital goods generally.

In the farm belt, prices were depressed by the conversion of the price support program to a more market-oriented system that reflected abundant world supplies of many agricultural products. In addition, interest rates paid by farmers in the last half of the year generally were around the 11 to 12 percent range, owing to the risk premia attached to farm loans. Many farmers who had taken on a large amount of debt during the boom of the 1970s continued to be squeezed by high debt-servicing burdens and by falling land prices.

Monetary policy in 1986 was an appropriate response to the deflationary forces that threatened the global economy. The decline in interest rates was market-led; long-term rates fell 2 to 2-1/2 percentage points between the summer of 1985 and the spring of last year. Given these considerations, the discount rate, which was 7-1/2 percent at the beginning of the year, was lowered in four steps, to 5-1/2 percent by August.

As we now look over 1987, the priorities for monetary policy remain essentially the same--to ensure a stable general price level in a world in which individual price adjustments continue to respond to world realities and expectations. Some of the unusual conditions of last year are behind us, but we continue to face important uncertainties--about movements in exchange rates and oil prices, about prospects for foreign growth, and about how successfully we will resist the pressures for protectionist trade actions.

The course of policy in 1987 will depend, in part, on how these uncertainties are resolved. All other things equal, should global activity weaken and deflationary tendencies reemerge, for example, an accommodative tilt to policy would be in order. On the other hand, if we see an unexpectedly sharp rise in oil prices in coming months and signs of larger increases in other prices and wages as well, a less accommodative policy clearly would be appropriate.

In any case, the critical element influencing the course of policy will be the performance of prices, not just this year but over the longer run as well. We have made substantial progress in the past five or six years in squeezing inflation out of the world economy. In many sectors of the domestic economy, including the federal budget, the cost has been high.

Nonetheless, the public still is skeptical that longer-run inflation is fully under control. Inflation expectations, of course, cannot be measured directly. However, from the available information, it would seem that inflation expectations fell noticeably in late 1985 and early 1986, apparently in response to the drop in oil prices and to the improved outlook for the federal budget associated in part with the Gramm-Rudman-Hollings legislation. Even so, inflation expectations remain disappointingly high. In this environment, it is critical to ensure that these anticipations of returning inflation are <u>not</u> validated by monetary policy.

I recognize that producer prices are not likely to fall in 1987, as they did in 1986. Petroleum prices have rebounded, and given the recent OPEC decisions on production levels, may tilt upward a bit more before peaking within the next few months. In addition, there may be some temporary upward price pressures associated with exchange rate adjustments. So far, the impact of the dollar on U.S. inflation rates has been small, as foreign producers have absorbed much of the effect of the exchange rate swing in their profit margins and some of whatever increase there has been in import prices has been absorbed by U.S. distributors. However, should the foreign exchange value of the dollar decline further--and if it is accompanied by a ratcheting-up of domestic prices--this undoubtedly would alter the price landscape and would be a monetary policy consideration.

I am not concerned by a one-time adjustment in oil prices or import prices, or that the general price level might rise a percent or so faster this year than in 1986. Over time, oil prices are going to go up and down, as is the exchange value of the dollar, and measured inflation rates may fluctuate as these adjustments occur. Rather, the danger is that a rise in oil prices or in nonpetroleum import prices may become embedded in the economy through wage-price interactions or through expectational effects, with the same destructive longer-run consequences that similar adjustments had in the 1970s.

Containing these inflationary pressures is as important as countering deflationary forces. Workers and businesses, confronted with the need to compete in world markets, must recognize that it is in their long-run interest to keep prices and wages at competitive levels, taking advantage of the opportunity to capture market share rather than raising prices in step with those of foreign goods.

In that regard, I am deeply disappointed in the behavior of the U.S. auto industry. In my view, the sharp increases in foreign car prices in the past few years provided a unique opportunity for domestic automakers to expand their sales. Instead, protected by the umbrella of the voluntary restraints on Japanese exports to us, GM and Ford jacked up their own prices--around 6 percent on 1986 models and another 2 to 3 percent so far this year. Not surprisingly, demand for their cars remains relatively fragile, with sales prospects continuing to depend on the availability of special incentives.

It also is important that the public be convinced that the Federal Reserve will adhere to its long-run anti-inflation goals. To the extent that restraint prevails in the private sector and that inflation expectations are checked, monetary policy can be more effective in promoting economic growth, while maintaining the long-run commitment to price stability.

This emphasis on containing inflation should not be viewed as a lack of concern about joblessness. Rather it reflects my assessment of the proper role for monetary policy, based on a reading of economic theory and practical experience. The evidence suggests that by striving to maintain price stability over time, we ultimately can have a larger and more favorable effect on economic growth and employment opportunities than could be attained by attempts to fine-tune the economy on a quarter-to-quarter basis.

Having indicated what I believe to be the appropriate objectives for monetary policy, there remain some important tactical issues. What economic variables should we be looking at in carrying out policy? Recent experience has suggested that monetary growth alone cannot guide our actions. The velocity of money has seemed erratic and unpredictable in recent years; few anticipated the big decline that has occurred.

As a result, monetary policy has had to rely on a broader range of variables, including importantly, I believe, the prices of commodities traded in auction markets. I think falling commodity prices in 1985 and early 1986 indicated what proved indeed to be an underlying weakness in the world economy and dangerous tendencies toward deflation. The actions we took helped to stabilize commodity prices. I am persuaded that the chances of achieving and maintaining general price stability will be greatly enhanced if we keep our eye on commodity price trends.

Developments in 1987 clearly will not be shaped by monetary policy alone. Successful economic performance also depends on progress toward reducing the size of the foreign trade deficit. With import prices rising as a result of dollar depreciation, the growth in imports should slow, and the increased competitiveness of U.S. goods should support export growth. However, a significant improvement in the trade situation will require satisfactory growth of demand in other countries, as well as open access to foreign markets.

In this regard, a disturbing implication of the huge trade deficit is the strength of protectionist trade pressures here in the United States. To succumb to these pressures clearly would invite retaliatory actions by our trading partners, curtailing our access to foreign markets. Moreover, higher prices for imports--either through direct controls on prices or arising from restrictions on quantities--would place a further obstacle in the path to price stability, thereby becoming a consideration for monetary policy.

The federal budget, of course, is another key influence. Consistent with the spirit of the Gramm-Rudman-Hollings legislation, Congress has made considerable progress over the past two years in slowing the upward trajectory of federal spending. Even so, unless substantial further reductions are enacted, federal outlays will remain historically high relative to GNP through the end of the decade. The latest estimates for fiscal year 1987 place the deficit at around $175 billion, underscoring the importance--as well as the difficulty--of budgetary restraint.

In closing, let me reiterate that, while satisfactory performance of the economy is important, attainment of price stability over time must remain the primary objective of Federal Reserve policy. The experience of the 1970s provides ample evidence of the great difficulties--and the appreciable costs--of gaining control of inflation, once it has been unleashed. In particular, we should not, through our own policies, create a situation in which a series of one-time price adjustments--such as a spurt in import prices or a protectionist trade action--can do serious long-run damage to the economy. We live in a world where future events are not always predictable and in which the "fine-tuning" of economic policy is not possible. In such circumstances, a commitment to achieving price stability over time ultimately will have the largest payoff for economic growth and job opportunities.

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