



FOR RELEASE ON DELIVERY  
WEDNESDAY, MARCH 18, 1981  
11:00 P.M. E.S.T.

---

ECONOMIC DEVELOPMENTS AND MONETARY POLICY

REMARKS BY

LYLE E. GRAMLEY

MEMBER, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

BEFORE THE

BOSTON ECONOMIC CLUB

Boston, Massachusetts  
March 18, 1981

My subject today is the outlook for economic activity and prices during 1981 and the role that monetary policy will play in the course of the economy. Let me begin by discussing economic developments since the middle of last year.

The typical economic forecast at mid-year 1980 was for a continued decline in real output during the second half and a weak recovery beginning early in 1981. When it became evident late last summer that economic recovery had already begun, but that strong pressures on interest rates were developing, the consensus forecast switched to expectations of a second economic downturn--beginning in the fourth quarter, or perhaps early this year. Instead, the pace of activity picked up in the fourth quarter, and has continued to be relatively brisk in early 1981.

Why has the economy been so strong during the past nine months? One could point to the run-up of defense orders, or the strength of energy-related investment spending, or the creative financing devices that have helped to sustain housing activity in the face of very high mortgage interest rates. I suspect, however, that the underlying reason is the powerful

effect of inflationary expectations on individual and business behavior. Anticipations of inflation are virtually as strong now as they were at ~~their~~ worst early last year. The steep, but short, recession of 1980 had relatively little effect either on the underlying inflation rate or on the public's perception of the outlook for prices.

During the past month or so, incoming economic indicators have been somewhat more mixed. Retail sales are still rising; capital investment plans are relatively strong, and the output of defense goods is gaining momentum. At the same time, auto production has been cut back in response to the earlier sluggishness of sales; housing starts declined in February, and industrial output fell for the first time since last July. A noticeable slowdown in real economic growth next quarter therefore seems probable, but the consensus among forecasters is that a serious recession this year is unlikely. The general expectation is that, following a lull in the second quarter, the pace of economic growth will pick up again in the second half in response to the tax cuts recommended by the new Administration.

The virtual disappearance of forecasts of a double-dip recession is of more than passing interest. Last fall, when interest rates began to increase rapidly, worries began to spread that the strategy of monetary policy adopted by the Federal Reserve in October 1979 had doomed the economy to continuing violent gyrations of interest rates and a corresponding process of boom and bust in economic activity. That policy change had freed up interest rates to move promptly in response to market forces of demand and supply. The fear was that each time the economy popped up out of recession, rising interest rates would bat it down again.

As I will argue later, restraint on money growth imposed by the Federal Reserve will put a substantial damper on real economic growth as long as inflation stays near its present rate. However, studies by Federal Reserve staff of developments since October 1979 indicate that the Federal Reserve's efforts to limit money growth, as implemented over the past year and a half, are unlikely to be a source of serious cyclical instability in interest rates and the economy. Economic developments since the middle of last year support that conclusion. Those studies also indicate that the pronounced variations in interest rates and real output we saw during 1980 were not principally the result of patterns of money growth but stemmed from other sources, including the impact of credit controls in the second quarter.

While it is true that most forecasters do not expect a serious recession this year, there are at least a few who are not so sure. Some of those who give a high weight to monetary variables in assessing the economic outlook have begun to worry about the recent sluggish growth of money balances. Adjusted for shifts into NOW accounts that became available nationwide on January 1, the level of M-1B (the more comprehensive measure of transactions balances) was about the same in February as it was in December. The worry is that the Federal Reserve has become a bit too zealous in its pursuit of monetary restraint.

This concern is, in my judgment, unwarranted. In December 1980, the level of M-1B was 6-1/2 percent above a year earlier--or at the upper end of the target range the Federal Reserve had set a year earlier. All of that money is still out there. Moreover, when growth in money slows for a brief period, as it has recently, careful analysis is needed of the reasons for the slowdown and what it means for the economy. For example, the slowdown may stem from inadequate reserve provision by the Federal Reserve, or the effects on demands for money and credit of a weakening economy. But it may also result from a reduction in the public's demand for money that reflects shifts in the form in which the public chooses to hold its liquidity.

In the present case, the last explanation seems the most likely. Economic activity apparently has advanced about as strongly in the first quarter as it did in the final three months of 1980. On this ground, demands for money should have remained robust. Had the Federal Reserve been overly zealous in its efforts to restrain money growth in the face of rising demand, interest rates would have shot up--instead of falling as they have since mid-December. Quite possibly, the nationwide spread of NOW accounts on January 1 prompted individuals and non-profit organizations to rethink their cash management practices, and thereby encouraged shifts of demand deposits to market securities, or other financial assets, as well as to NOW accounts. This explanation is suggested by the fact that a similar brief slowdown in growth of transactions balances occurred after the introduction of ATS deposits in late 1978.

I have discussed this recent slowdown of money growth in some detail because it is important for the public to understand why money growth often proceeds at an uneven pace. The Federal Reserve's objectives for monetary expansion are, as you know, set forth each February for the calendar year in progress. We in the Federal Reserve know, both from intensive study and extensive experience, that short-run control of money growth is very imprecise. We also know that there are times when shifts

in the demand for money, reflecting a restructuring of the public's financial asset holdings, mean that a consistent monetary policy aimed at reducing inflation must permit temporary deviations of money growth from our targets.

Since 1974, new forces have come along that have affected powerfully the relation between money, economic activity and prices. These new forces have tended to decrease the amount of money needed to finance a given volume of transactions. While they have done so at a very uneven pace, the amounts of money involved have cumulated to huge magnitudes, so that they cannot safely be ignored.

When a slowdown in money growth occurs, we in the Federal Reserve can never be 100 percent sure why it is happening. In light of the history of the past seven or eight years, however, we are acutely aware that if every weakening in money growth for more than a month or two is taken as a signal to step on the monetary accelerator, we could seriously aggravate our nation's inflation problem.

It is regrettable that a consistent, steady, monetary policy does not always mean a steady rate of growth in the monetary aggregates from month to month and quarter to quarter. Our problems of credibility would be reduced if that were the case. We do not ask the public to accept what we do on blind faith. But we do believe that your understanding of monetary policy would be improved if you recognized that short-term variations in the pace of money growth are at some times unavoidable, and at other times actually desirable.

Let me return now to a point that I made earlier-- namely, that consistent restraint on the growth of money and credit will, until inflation slows substantially, put a damper on how much the economy can reasonably be expected to grow in the second half of the year and on into 1982.

The Federal Reserve announced its targets for monetary growth in 1981 in its report to Congress a few weeks ago. For M-1B, the more comprehensive measure of transactions balances, the target range is 3-1/2 to 6 percent (adjusted for shifts into NOW accounts). For M-2, which also includes savings and time deposits of individuals at commercial banks and thrift institutions, the range is 6 to 9 percent. Our current intention is to reduce these target ranges in the years ahead.



The history of the past decade indicates that growth of M-1B at less than 6 percent, or growth of M-2 at less than 9 percent, would not sustain an increase in the current dollar value of the Gross National Product of much over 10 percent for an extended period. But if inflation were to continue at roughly the 10 percent pace of the past year, this would mean that little or no room would be left for real economic growth. To put the matter a different way, a 6 percent rise in transactions balances is roughly what is needed presently to finance a 10 percent inflation at a constant level of real output.

The relations between money growth and GNP are by no means fixed, as I have already noted. But neither are they indefinitely flexible. Given our monetary targets, growth in current dollar GNP at a pace significantly above 10 percent tends to put strong upward pressures on interest rates so that sooner or later economic growth begins to be choked off.

Monetary restraint does not, unfortunately, work directly on prices. On the contrary, its initial effects are on real output and employment. As the experience of the past year and a half indicates, the process of reducing inflation through monetary restraint is an excruciating one, once

inflationary expectations have become deeply embedded in economic decisions and economic institutions. When monetary restraint takes hold, it reduces employment and real incomes; pushes interest rates to painfully high levels; threatens the viability of thrift institutions; imposes enormous losses of sales and profits on homebuilders, auto dealers and other small businesses; results in a growing backlog of needs for housing, and even affects adversely the growth of business capital investment that we so badly need for productivity improvement. And its effects on inflation occur with agonizing slowness. The economic distress occasioned by firm monetary restraint since the fall of 1979 has kept inflation from getting worse, but as yet there are no clear signs that the hard-core rate of inflation has begun to come down.

Over periods of several years or more, prices track closely with costs. In 1980, unit labor costs rose about as fast as they had in 1979. Productivity declined again, although not so much as in 1979; hourly compensation of employees actually rose a little faster than in 1979. Higher unemployment and weak markets has had some effect on wages. Nonunion wages, for example, rose somewhat less in 1980 than in the previous year. Moreover, the UAW contract with Chrysler was reopened, and there

is speculation that the contracts with Ford and GM may also be modified. Realistically, however, there is little hope for more than small progress this year in reducing the rise of wage costs or the rate of advance of industrial and service prices.

If you ask why the Federal Reserve persists in its policy of restraint in light of these disappointing results, the answer is that there is no real alternative. Reducing the rate of expansion in money and credit is an indispensable ingredient of any anti-inflation program. But there is no reason why our country must, or should, fight inflation with monetary policy alone.

We in the Federal Reserve are extremely encouraged by the efforts presently underway by the new Administration and the Congress to hammer out agreement on an effective anti-inflationary budgetary policy. It is of fundamental importance, I believe, that the budget deficit be brought down as rapidly as possible. The projected deficit of \$45 billion for fiscal 1982 is worryingly large. If economic growth did not proceed as rapidly as expected in the Administration's forecast, if interest rates did not decline as much as expected, if agreement were not reached on all the expenditure cuts recommended by the

President, the deficit could easily be much larger. If that happened, conditions in financial markets would go from bad to worse. We would be well advised to remember that the surest way to increase the aggregate amount of national saving available to finance investment through Federal budgetary policy is to reduce the Federal deficit.

The President's new economic program seeks to reduce inflation in a variety of ways: by reducing the costs of government regulations, by increasing productivity through tax incentives for business investment, by expanding energy production, by encouraging individual work effort through reduction in marginal tax rates, by supporting continued monetary restraint, and other means. By moving massively on a variety of fronts, the Administration hopes to effect a dramatic turnaround in inflationary expectations and thereby encourage economic decisions that would bring inflation down rather quickly.

This approach to fighting inflation puts great weight on the judgment that our present inflation problem is heavily a consequence of inflationary expectations built up because the rate of inflation has been rising for almost two decades. That judgment is, in my view, a valid one. But no one can be sure what it will take to convince the public that inflationary

behavior will no longer be rewarded by economic developments, or how soon visible results on the inflation front will be achieved. The President was therefore wise to counsel the public, as he did recently, not to expect immediate results.

What we do know, however, is that achieving a turn-around in the public's views about the inevitability of inflation will require a consistent anti-inflationary stance in every area of economic policy--not just this year, but for the foreseeable future. Any major policy decision that appeared to be at variance with a strong anti-inflationary stance--whether it be Congressional unwillingness to make the hard decisions on expenditure cuts, import restrictions on autos or other goods, or a backing away from a firm commitment to monetary restraint--would have a severely damaging effect on public confidence. I can assure you that the Federal Reserve, in its area of responsibility, will do all it can to ensure that our national effort to end inflation is successful.

#####