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"POLICY CHALLENGES"

by

Edward W. Kelley, Jr.

Member

Board of Governors of the Federal Reserve System

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As we approach the last year of this decade and prepare to enter the 1990s, it may be an appropriate time to take a close look at the challenges that will face our nation and its policymakers in the upcoming era. I would also like to take brief note of the crucial role of the private sector in meeting these challenges.

Let me start with what I see to be the basic objective of public financial policy, then proceed to take a look at where we are today and, with those two viewpoints in mind, proceed to speculate on what needs to be done.

The basic objective public financial policy needs to strive for, in my view, is stability. Let me hasten to say favorable stability as, after all, comatose is a stable state. And that obviously will not do. The reason stability is so important is that it allows economies to operate at maximum efficiency. If an economy is working well it, in turn, opens up opportunities to make progress in all of the different facets of national concern. If it is not, it will be very difficult to make progress anywhere.

What then are the characteristics of this stability? It is desirable to smooth the cyclical oscillations of economic activity. It is desirable to have low real rates of interest to facilitate a strong flow of products from producer to market and to encourage productive investments at a reasonable cost of capital. It is desirable to have an inflation rate that is slowing over time towards zero and that also is not constantly threatening to rise up and bite us like an untrustworthy pet. Last, but not least, it is desirable to have international trade conditions that expedite rather than impede flows of economic activity, and in the area of financial management this primarily involves exchange rate stability.

Before examining how to move toward this state, we must first reach some understanding of where we are today. Let me use the analogy of a happy group on a joyful summer picnic who, as they enjoy themselves, notice a thunderstorm coming across the horizon.

First the picnic. We are entering the seventh year of an expansion that still appears to be healthy. Jobs are being created in the United States at a rate that is unique in the world. Unemployment is now well below 5-1/2 percent and falling. The Gross National Product has been growing at a healthy rate and 1988 will close out meaningful above 1987. Inflation over the '80s has fallen dramatically and many industries, indeed entire geographical regions, have been restructuring and renewing themselves and promise to be strongly competitive in the years ahead. It is indeed a wonderful picnic -- but that thunderstorm is brewing.

The thunderstorm, of course, consists of the twin deficits that we are running in the area of balance of payments and the fiscal budget.

It may be appropriate to take a look at each of these, as some say that they do not matter and should not be a source of public concern. First, the fiscal deficit. Regardless of one's view of whether or not the absolute level of the United States public debt is significant, surely several things do matter. First, this debt must be serviced and interest now amounts to almost 15 percent of the Federal budget. This clearly introduces an element of fragility in times of pressure and serves to reduce the flexibility of public policy. Second, it clearly diverts capital that is needed for investment and other socially desirable uses. Lastly, deficits induce an inflationary bias to the economy and large ones, particularly those financed externally as ours' are, introduce a large bias.

The balance of payments deficit largely consists of our trade deficit. Here the concern, once more, is the need to finance it and we are dependent for this upon foreign capital. Much of this capital is held in the form of financial instruments and as such it can potentially be withdrawn at will or, at the very least, foreign holders can decline to continue to invest additional sums except at higher and higher cost. Such conditions are clearly damaging to the quest for stability. Second, this deficit puts pressure on the exchange value of the dollar, and should it plummet through speculative activity, important inflationary pressures could be aroused with possible adverse affects on interest rates and the creation of a boom and bust type of atmosphere.

In light of the above, it is my opinion that these clearly are problems that must be dealt with and constitute the major policy challenges we will discuss next.

How can we reach a more stable economic environment with these twin imbalances in the way? There are enormous incentives to succeed in this effort as there are very powerful economic forces at work in the economy, and in our social system, which could move us toward a very favorable era in the near future. However, it is unlikely that we will achieve a high percentage of this promise and potential without dealing with the twin deficits. Indeed, sooner or later, purposefully or willy-nilly, they will be dealt with. Sooner, and proactively, is clearly the better way as the economy will be held back until progress is made in this area. Indeed, we will continue to risk severe setbacks so long as they remain unaddressed. Selecting the best ways to attack the problem represents a major challenge in itself. There are Draconian ways which could result in cures that might be as bad as the disease. What we must search for is the existence of alternatives wherein everyone will be a winner.

What should be the proper order of attack? This is a particularly important question today in light of the fact that we now have an economy that is operating at, or near, full capacity even as these twin deficits are being generated. We have made very substantial progress on our balance of trade deficit over the past year and a half but we may soon be confronted with a dilemma if we continue to pursue a solution in that area alone. If we keep pushing for export growth, in the hope that this will enable us to grow out of both problems simultaneously without any demand restraint on our already very full economy, we may soon risk overheating with an attendant increase of inflationary pressures. This danger could be heightened by a substantial further decline in the exchange rate of the dollar. If, on the other hand, we choose to attack the problem on the import side through cuts in demand, we could run the risk of an unnecessary early recession. Thus it seems to me that it could be counter-productive for us to continue to single-mindedly attack the trade deficit in isolation, hoping it will lower the budget deficit as growth rolls along. Let me quickly add that our dollar is very competitive in world trade today and, thus, we can look for continued improvement in our balance of trade deficit, albeit at perhaps a lower rate. Under today's full economy conditions, that may be just as well.

The reverse approach will work. If we can attack our fiscal deficit problem correctly, the balance of trade deficit should shrink along with it. The fiscal deficit can be reduced slowly if it is done is an atmosphere of impeccable credibility, as the international financial community must see and accept that the United States is on an irreversible path towards a balanced budget. I am a strong believer in trends and I feel that if it is very clear that a favorable trend is in place, then that is far preferable to any one absolute deficit figure which is achieved in an off-again on-again manner. As we slowly reduce the budget deficit, we should use the slack so generated to encourage a higher level of investment in productive capacity coupled with a slowing in the increase of domestic consumption. As expanded capacity comes on stream, some of it will be directly export oriented and with the dollar now competitive and other economies strong, opportunities for sales expansion will clearly be there. Some of it will be slanted toward domestic consumption and this will help to slow the rate of imports, which is equally important. Thus, the fiscal and balance of payment deficits can improve together in a symbiotic manner, if appropriately pursued.

So here is the challenge for the policymakers in the upcoming period. In economic terms it does not appear to be terribly difficult but in political terms there is no doubt that struggles lie ahead. But to repeat myself, if we are able to succeed here we will have every opportunity to succeed in a wide variety of desirable initiatives whereas to fail here will severely reduce such chances and may soon result in our economy facing unwanted and unnecessary problems.

Monetary policy will clearly have an important role to play. If we get the type of policy initiatives enumerated above, it will represent a sea change in the financial environment. We will have changes in real and perceived inflation pressures; flows of economic activity, both domestic and international; interest rate structures; and the dynamics of exchange rates. More important than any of the individual items enumerated above, will be how they will interact one with another.

The precise impact on Federal Reserve policy is difficult to foresee. I suspect that as these shifts evolve, it will give a new look to old problems. If policy remains too tight, there will be a risk of aborting a beneficial process. If it should become too loose, and thus recreate excess demand, inflationary pressure could reemerge which could, in turn, also abort the beneficial process. It will be necessary to sort out what of the familiar and well understood is still in place and functioning, what is new, and what to do about it. My fondest hope is that these are the sorts of problems we will face.

Let me close with a word about the pivotal role the private sector will play in this drama. It seems to me we must regain our long-term perspective on what constitutes true economic value. I fear we have slipped into a "quick buck" mentality in this country, which I would suspect was born in the late unlamented inflationary era. It is manifested in a wide variety of speculative activity that permeates much of our financial world, and the effects of these financial gyrations can be devastating on the operating businesses that we depend upon to make our economy go.

Real economic value is found in solid long-term strength: well trained, motivated and loyal employee groups; market acceptance earned through offering good products at reasonable prices; new products developed through research and then carefully and patiently nurtured; low cost efficient plants to produce them. These things and many others are the stuff of real economic value. In the final analysis, regardless of what public policies may be in place, it will have to be the private sector that gets the job done in the world market and it is only through concentration on these traditional elements of good business practice that this can be achieved.

Let me end where I began. What our economy needs from public financial policy is a climate of stability on favorable levels. If we can move toward this we have a great opportunity to make important progress and could, indeed, very quickly move toward a highly favorable era. This is clearly worth working toward and I am confident that it is the way that we will go.