For release on delivery
12:00 Noon E.D.T.
Tuesday, May 10, 1983

Remarks by

Preston Martin
Vice Chairman, Board of Governors of the Federal Reserve System

before the

Society of American Business and Economic Writers

Washington, D.C.

May 10, 1983

I am pleased to be here this afternoon as a guest of the Society of American Business and Economic Writers on the event of your 20th annual meeting. Think back with me twenty years to the 1964 period; recall the stability and predictability of economic growth, the credibility of fine tuning monetary and fiscal policies, and this nation's leadership in the global economy and polity. I lived in Rome that year, where my best received speech to Italian bankers was "The Secrets of American Productivity." At the Banca d'Italia, Guido Carli was reminding his countrymen that Italia was no longer primarily an agricultural society!

The U.S. today differs more from 1964's than from 1983's European Community. Today there beckons a rare opportunity to achieve a measure of the stability and productivity we so took for granted twenty years ago. Most of us work in services, not manufacturing nor agriculture, and service employment has risen over the last 60 days by 200,000. We are continuing a long trend toward more business writers and computer programmers and less sheet metal workers.

Employment in services is enveloping manufacturing in the societal evolution that transformed farmhands into production line workers at an earlier stage. Our agriculture remains outstanding--the task today is to regain industrial excellence, to transform and extend manufacturing with computer software and robotics. Our position in the world economy will depend on such factors as our return to "serious" intellectual pursuits in education, upon techniques like distributive informational processing, and upon organizing the production of goods and services in small, interactive work groups. Of course the attitudinal aspects loom large. Work satisfaction and thus motivation is still in part money motivated, that is "real" money wage or salary, and that is precisely where inflationary expectations enter the productivity equation. Less inflation affects the work ethic, discourages "buy now" and stimulates saving habits. "Buy later" may shift the demand curve for monies and liquid assets a little. Monetary policy's task becomes easier if velocities (turnover) of deposits and other liquid assets are more stable. Disinflation lowers the hurdle rate for business investment.

Certainly the recovery does not depend primarily upon structural adjustments in the labor markets. The familiar indicators are raising their hands. Demand in the labor markets seems to be firming as indicated by the rise in total employment and lengthening of the factory workweek in April. Last month's further trimming of inventories in the manufacturing sector combined with a 2.5% increase in shipments, brought the inventory-to-sales ratio in that sector to near the pre-recession levels of early 1981, and should set the stage for further gains in production and employment.

Perhaps the most dramatic of these portents however is the increase in housing sector activity over the last several months. Housing starts in the first quarter were 34% above their fourth quarter 1982 level and the pace of new and existing home sales had surpassed a 3 million unit annual rate during the first three months of this year. Activity in this credit-sensitive sector provides positive evidence of the effects that the moderation in interest rate levels and inflation expectations has had in recent months.

Climatologists have styled April as the cruelest month, alluding to its variability. Looking backward from this year-end, economists are not likely to so characterize this month: April's data are decidedly stronger. Still there is the conundrum of federal megadeficits, so let us address them.

Many had hoped that major fiscal policy decisions would be in place by this time, decisions which would indicate lower spending and higher revenues than were postulated by the OMB and the Congressional Budget Office for 1985 and beyond. While those hopes have not yet been realized, note that the fiscal debate continues to be responsive to spending and revenue considerations which five years of massive deficits would entail: we are no longer content to plan year by year.

That is not to deny the major risk both in recovery for 1983 and in trend-to-1988 of the prospect of continued federal mega-deficits over the next five years. As a practical matter, mega-deficits create the potential, as the recovery picks up, for demands from institutional portfolio managers for continued high interest rates: high real rates which would impede prospects for a renaissance in jobs, in business investment, exports and in housing.

Outyear megadeficits tend to create doubts as to the prospects for the very success of economic policy--perhaps the capacity of economic policy--to contain inflationary pressures over the long run. When doubts solidify, they constitute an unsettling influence on financial markets. Perhaps the greatest of all impediments to defeating inflation and a prime reason disinflation exacted such costs from our work force and our businesses, has been the deep skepticism of those in the marketplace that economic policymakers could and would keep up the fight.

Megadeficits have a further damaging effect: they distort international capital flows. Many weeks like the last one of funding $15 billion for Treasury may in time bring upward pressure on interest rates. Relatively high real rates in turn attract capital from abroad and may influence dollar exchange rates and eventually the competitiveness of our goods and services in foreign markets. To some extent a strong dollar contributes to the loss of jobs in export industries and a worsening of the trade deficit.

Though the continued movement to fiscal responsibility is needed in order to reinforce the progress of economic recovery, the prognosis is not all negative. Cynics were confounded by last year's election year tax increases. It is still too early to listen to counsels of despair: the 1984 fiscal year budgetary process is still in an early stage.

In spite of the presence of these real risks, there is room for substantial optimism about maintaining the progress against inflation and promoting a sustainable recovery. There has been an exceptional advance towards the restoration of price stability and, better, there exist indications that this progress can be sustained. Granted, fortuitous events in the energy markets have substantially assisted the price indicators. In this regard, I am reminded that supply surpluses are often succeeded by future scarcities. But this factor need not be entirely temporary. We have in place long-run energy economizers--smaller cars, energy-efficient furnaces and appliances, better insulated homes and offices -- and, in the context of a long-term success in curing inflation, basic cost trends--particularly wage increases--have moderated substantially. This is the stuff of a firm foundation for stable prices.

Another critical change favoring an environment of disinflation and growth comes from the improvement in productivity. This is an encouraging reversal of the trend over the last several years. Even at this stage of a recovery, the increases in productivity have been strong, indicating a potential for a very gradual trend of basic labor costs. Last year's productivity advances -- which first quarter data extends--is not only an indicator of downward pressure on costs. It is much more than that. It is only--repeat, only--from increased productivity that we can get a real and general increase in our standard of living.

Monetary policy can contribute to a truly noninflationary economic recovery, sustainable over a multi-year period, not just a few quarters. Today, the opportunity before us is to continue breaking away from a cycle of accelerating inflation, depressed business investment, declining productivity and loss of international market share.

The early characteristics of this recovery do not indicate a need to alter the direction nor the objectives of monetary policy. I believe there is a new awareness of both the ubiquitousness of foreign competitors and the importance of jobs related to the export of goods and services. Management staffs are leaner, work rules are more flexible, and the computer revolution is reaching down into small work groups (just as you wrote might happen four or five years ago). Certainly the economy has recovered rather than rebounded in comparison with other early post WW II cycles, but that augurs well for disinflation and for level or declining interest rates for some period.

It is vital for the longer-run prospects of the economy that both inflation and the specter of inflation--inflationary expectations--should continue to abate. If this is to happen, we must achieve the continued support of both fiscal and monetary policy. It is the economic events that transpire in 1984 and 1985--as the recovery gains momentum--that will be of crucial importance in determining whether we have indeed achieved an environment that will foster sound economic growth.

Thus it is important that the Federal Reserve continues to pursue long-term price stability. The current environment, however, is not one that lends itself to policy implementation simply by entering the data into a computer program and implementing the results. As commentators on the scene, you are best aware of the exogenous changes and disruptions to the financial markets and financial institutions brought about by recent technical, international and domestic economic events. As you know, the implementation of monetary policy is specifically through financial markets and institutions, affecting nominal aggregates. Events that impact the financial instruments, products and market structure influence our evaluation of the trends in the reserves and monetary aggregates and to me require perspective on the most doctrinal approaches to monetary policy.

A case in point is the atypical behavior of money velocities over the last year. The drop in money velocities has been attributed to a number of factors including the massive introduction of M1 and M2 based deposit instruments, shifts in international credit flows and an increase in the public's liquidity demands. This latter trend could prove to be, at least in part, a temporary phenomenon followed by some unwinding of the exceptional liquidity demands with the strengthening of the economy. Some residual holding could be a function of lower interest rates and persisting unemployment. Nevertheless, money velocities in 1983 could follow a pattern different from past recoveries.

In addition to the changes occurring in financial markets, I believe that we will witness a recovery in 1983 that is substantially different from others in the post-war experience. I have mentioned fundamental shifts to service industry employment over the last decades that have contributed to economic dislocation and distress. These shifts, still continuing and with far to go, will require a judgmental approach in interpreting the recovery, not an approach simply cued by the numbers from past recoveries.

The most recent movements in the growth of the monetary and credit aggregates have been a supportive indicator of our monetary policy goals. The most recently released data for the M3 and M2 aggregates show a deceleration of their growth from the exceptional levels experienced at the beginning of the first quarter. As you know, an associated range for the growth of total domestic nonfinancial debt in 1983 was estimated by the FOMC. The use of this aggregate is as an informational, rather than a target variable--its behavior is monitored to provide assistance in judging appropriate responses to developments in the other aggregates. Initial data indicates that growth in the domestic nonfinancial credit sector during the first quarter will be well within the estimated range, and in accordance with long-term projected trends.

Obviously, formulating generalizations from these few weeks is not feasible, especially when considered in light of the contribution that the above-mentioned factors have made to the complexity of interpreting the performance of the aggregates. The FOMC will continue to utilize a high degree of judgment in evaluating the growth of money and credit and, for the time being, will continue to place substantial weight on the behavior of the broader aggregates in implementing monetary policy.

In summary, the economic outlook is more encouraging, though there exist weak spots in the recovery and indications are that the initial stages of that recovery will be less robust than in our previous post-war experience.

The chances that this recovery can be sustained over a period of time have been considerably enhanced by the exceptional progress made against inflation over the last year. However, there exists a prominent risk to solid growth in the current outlook for continued federal budget megadeficits over the next several years. This risk can manifest itself in the continued upward pressure on interest rates and dollar exchange rates, and if not addressed constructively, could create a serious problem in regards to the longer-run outlook for the economy.

Another area of risk to the recovery is the strain existing in the international finance sector and the economies of our major trading partners. The LDC debt question is of most immediate concern as it affects the orderly functioning of markets and could affect the general prospects for U.S. economic growth. In that regard, I would propose that timely and constructive action in support of the IMF and like international agencies is essential to a successful resolution of this problem. In the longer run, the prospects for renewed international economic growth of the developed countries and the maintenance of relatively unrestricted trade will be a key. The international debt burden is manageable, but it will not manage itself.

We have experienced the difficult adjustment process of restructuring for a productive economy after a decade of low productivity and destructive inflation. We cannot afford to return to those conditions--the human and economic costs of disinflation have been incurred and cannot be allowed to be wasted or recur.

Monetary policy will continue to play a constructive role in promoting sustainable recovery characterized by stable prices, a long period of good returns on investments, high employment and economic growth. Success does not rest in the hands of monetary policy alone, but will be the result of a concerted effort from all areas--government, business, labor and others--to solidify and promulgate the successes experienced to date.

* * * * * *