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Current Issues in Monetary Policy

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This is an especially appropriate time to meet to discuss foreign policy issues because of the growing recognition of the cumulative effect of import competition upon our economy and indeed our whole society. The current estimates of sluggish domestic economic activity are evidence of the stepped up impact of imported goods and services on the U.S. economy. Financial markets are adjusting to the realities of massive foreign investments and the very idea of the United States as a debtor nation. The Eurodollar markets offer alternative sources of funding for companies like yours. Finally, Treasury Secretary Baker proposed further discussion of certain aspects of international monetary matters at the OECD annual meeting in Paris. If there exists anyone who is not aware of international interdependence today, let him contemplate Friday's news report of the rise in Swiss Franc futures following news in the U.S. of slower-than-expected first quarter real GNP growth!

The strength of the dollar and the changing conditions in world financial markets are important considerations in both the structuring and the implementation of U.S. monetary policy. In explaining the circumstances leading to the two discount rate reductions within a month of each other at the close of 1984, our Board was careful to acknowledge the high level that then prevailed for the trade-weighted dollar and also cited declines in commodity prices. Similarly, the Federal Reserve is aware that the high level of real interest rates in the U.S. affects real rates in the markets of our trading partners through the linkage of global investment decisions. In turn, high interest rates in Europe and market pressures for deregulation in Japan affect growth rates in those countries, and thus your markets there.

Important as interest rates and foreign exchange market conditions are, Federal Reserve policy objectives for 1985 emphasized disinflation and sustaining the economic expansion, without differentiating them as to priority. Target ranges were enunciated for three monetary aggregates, and a monitoring range was specified for the growth of domestic credit. As in previous years, in each case, target ranges were specified rather than a single growth rate, to preserve a degree of flexibility in executing policy in a world characterized by unexpected developments. Indeed, an important point of deliberation at the February Federal Open Market Committee meeting was a concern that there could be need for flexibility this year, as one or more of the monetary aggregates moved along or somewhat above the upper boundary of its range, especially early in the year.

Of course, our Committee's expectation was that the specified ranges were consonant with feasible progress for the economy, a central tendency of 3-1/2 to 4 percent for real GNP growth with stable inflation, and some improvement in the unemployment rate. As 1985 developments have disappointingly unfolded, the short-run demand for money has grown rapidly compared with GNP, as indicated by sluggishness in the turnover of money--the so-called velocity of money--as I will explain a little later.

The Framework of Monetary Policy

As you know, the Federal Reserve formulates and implements policy primarily in terms of target ranges for growth in the monetary aggregates (M1, M2, and M3), and with an eye on growth in total domestic nonfinancial debt. We give narrower money measures, M1 and M2, the most weight because they are found to have the most reliable relationships with GNP and prices.

The inherent lags in monetary policy's impact on the economy are an important reason for focusing on monetary aggregates. The conduct of policy is complicated by a normal lag of from 3 to 6 months from policy actions to the subsequent growth in output, and of somewhere around 1-1/2 years to their associated effects upon inflation. Because of these lags, it is not feasible to conduct effective policy by looking only at current economic developments. Such a policy would be "fine tuning," overly reactive, and it could be destabilizing if pursued on a quarter-to-quarter basis. So the decisions made by the Fed so far this year are relevant to real growth later in the year, but are not likely to affect disinflation until after mid-1986.

But while recognizing the importance of the monetary aggregates, it also seems to me that an eclectic approach to policy serves the public interest best--it does not make sense to "throw away" information or to follow mechanically any one school of thought. Thus, in addition to monetary variables, one looks at the myriad of monthly and quarterly statistics on the progress of the economy, including indicators of international economic developments. Any well-reasoned discussion of plans for policy in 1985 obviously must involve evaluation of current economic conditions, and a variety of "leading indicators." Let me turn, therefore, to the economic outlook.

Economic Outlook

It is widely recognized that over longer time spans, inflation is a monetary phenomenon, and that the central bank can best contribute to disinflation by reducing money growth rates gradually over a period of years. Since 1979, when monetary aggregates were emphasized by the Fed, inflation has been reduced significantly from 9 percent in 1981 to around 3-1/2 percent in 1984 (as measured by the GNP deflator). Along with the decline in recorded inflation, there also appears to have been a drop in expected inflation. The March 1984 "Decision Makers Poll" by Richard Hoey and Helen Hotchkiss, for example, shows 10-year inflation expectations having dropped to 5-1/2 percent compared with a peak of almost 9 percent in 1980.

The probability of inflation reaccelerating this year, or even next year, seems smaller than has been characteristic of recent expansions, and inflationary forces may even have some downward momentum, on balance. Wage inflation and productivity are among the most important factors in the outlook for disinflation. For 1984 as a whole, favorable developments in compensation per hour and productivity produced an increase in unit labor costs of about 1-1/2 percent in 1984, compared with a very high 9 percent average increase in 1978-82.

These trends seem likely to continue. Wages in major union contracts agreed to last year were down even from their relatively low 1983 levels. A respectable band of analysts now thinks that productivity is on a new higher trend line, up from its sluggish performance in the 1970s.

On balance, the degree of slack in world markets for the factors of production also is favorable for disinflation. In the U.S. labor market, the civilian unemployment rate stood at a high level of nearly 7-1/2 percent in March. For total U.S. industry, the utilization rate currently is well below its average or "full" utilization value of the previous 15 years. Moreover, excess capacity abroad also keeps downward pressure on U.S. prices, since this capacity may be "passed through" to U.S. consumers through a surge in imports.

Commodity prices and exchange rates have also applied downward pressure to inflation in recent years. Prices of industrial materials have fallen by about 14 percent over the past year. In one important area, oil prices, the risks may still be somewhat on the downside, even given OPEC's recent steady performance.

Of course, a worrisome factor for reinflation is a possible sharp, sustained decline in the value of the dollar. The rising dollar thus far in the 1980s, of course, has put downward pressure on inflation but has contributed to massive trade deficits, which have helped finance federal budget megadeficits and kept real interest rates in the U.S. lower than they would otherwise have been. The majority of analysts argue that the dollar eventually must decline by a significant amount of its own weight, if large trade deficits persist. They argue that foreign portfolios eventually will become saturated with dollar-denominated securities, and that as a consequence the demand for dollars will fall. This is a sensible argument; but the all important question is of timing, about which unfortunately little seems to be known. Will the saturation level be reached this year, in 2 years, or in 5?

The dollar, in fact, has declined rather sharply in the last six weeks or so. There is no good evidence to attribute this decline to the saturation of foreign portfolios with U.S. securities. It also seems unlikely to me, by the way, that it was primarily a function of central bank intervention in the foreign exchange markets. Studies stemming from the Versailles summit indicate that such intervention appears to have limited power to overcome fundamental factors affecting exchange rates, although intervention can from time to time be beneficial in stemming disorderly exchange rate movements or in reinforcing market strength or weakness if used selectively.

Changes in several fundamental factors seem to have contributed to the dollar's decline. One was the growing perception in the markets that the U.S. economic growth had weakened somewhat, and thus that the chances of the Fed tightening monetary policy had diminished. In addition, the Ohio thrift situation raised the prospect in the minds of some market participants that the stability of the U.S. financial system might not be as absolutely secure as previously thought. Once it was clear that the Ohio situation was delimited, this influence on exchange rates seemed to wane.

Nevertheless, this experience serves to warn us of the importance of the safe-haven motive for holding dollars, and highlights the difficulty in anticipating exchange rate movements in detail. As I mentioned, this uncertainty about exchange rates raises doubts about future inflation. A decline in the trade-weighted dollar erodes the profit margins of foreign vendors and perhaps those of their distributors in the U.S. This process is not likely to produce instant inflation, however, as sellers may accept smaller margins on sales to hold their shares of U.S. markets.

Finally, let me note that some analysts became concerned that reinflation was suggested by the Commerce Department's "flash" estimate for the first quarter of this year which showed the GNP deflator advancing at a 5-1/2 percent rate (confirmed by the revised estimate released last week). However, this should not be overemphasized, since in large part it reflected distortions due to large shifts in the composition of imports. A more accurate picture is given by the gross domestic business product fixed-weight price index, which increased at a lower 3-3/4 percent rate in the first quarter.

Turning to the outlook for the real economy, there seems to be a reasonable chance that GNP will show a healthy but moderate increase for 1985 as a whole, hopefully enough to avoid a growth recession (defined as slowly rising GNP and a rising unemployment rate later this year). In broad terms, this possible outcome seems to be supported by reductions in real interest rates since mid-1984, and recent rapid growth in the monetary aggregates. Despite increases in long-term interest rates in the past two months, the inflation-adjusted 10-year Treasury rate still is over 100 basis points below its May 1984 peak. Although M1 decelerated in March, it has grown at a rapid 10 percent rate since last October 1984.

However, a growth recession must be considered a real threat. In fact, the data currently available suggest that the economy is on the edge between healthy, sustainable growth and a growth recession. If the Commerce Department is roughly correct in its 1-1/4 percent estimate of first quarter real GNP growth, the economy has advanced at only about a 2-1/2 percent rate over the past three quarters. I am not aware of solid analysis suggesting that 2 percent growth would produce a perceptible reduction in unemployment rates.

The index of leading economic indicators also presents a mixed picture of the future. Despite recent strength, the index still is below its peak of last May. The sharp rise in new orders for nondefense capital goods in February was encouraging. However, one should not become too optimistic since these orders had fallen on balance over the previous two quarters. The sharp increase in housing starts in March might be considered encouraging, except that nearly all of the increase came in multi-family units. Given the apparent overbuilding in U.S. submarkets, it is difficult to see how the most recent high level of starts can be maintained.

In the first two years of the recovery, the strong dollar and the associated trade deficits were considered by many to be an "engine of worldwide expansion" whereby our trading partners could stimulate tardy recoveries, and a source of dollar exchange for less developed countries. But, as our trade deficits have escalated to unprecedented levels, the dialogue has turned to the loss of American production and jobs, some of which appears to be permanent. To the extent that sectoral imbalances adversely affect the prospects for growth in the U.S. economy, it will be especially burdensome for future "debtor-nation" generations to pay off the large debts, some of which are owed to foreigners. Thus the strong dollar not only is one source of uncertainty about price developments as I mentioned earlier, but also about trends in the real economy in the near term and beyond.

The Monetary Target Ranges and Velocity

The outlook I have just described--essentially risky for economic growth, with a chance of further disinflation--conditions an interpretation of the target ranges for the monetary aggregates in 1985. The 4-7 percent range for M1 involved a one percent reduction from 1984 in the upper boundary, while M2's 6-9 percent range was unchanged from last year; and there were slight increase in the ranges for M3 and domestic credit. Congressional testimony by Chairman Volcker included the caveat that one or more of the aggregates might grow in the upper parts of their ranges during the year. Federal Reserve charts show the ranges as moving within parallel bands, in addition to the cones or wedges displayed in the past. The parallel bands give room for faster money growth early in the year than do the cones.

The reduction in the M1 range is consistent with the Fed's policy of disinflation, of gradual reductions in monetary growth over the long run. Even in the case of M1, growth in the upper part of the range would exceed the 5-1/4 percent growth rate last year. M1 grew at a 10-1/2 percent rate in the first quarter compared with its 7 percent upper boundary, and M2 grew at a 12 percent rate compared with its 9 percent upper boundary.

These observations naturally raise a question about the thrust of policy: now that inflation seems to be better under control, is the Fed implicitly or subtly deemphasizing its objective of further reductions in the inflation rate? Not at all. My main point this afternoon is that there are solid technical reasons for these changes in monetary ranges and for the flexible implementation of policy exercised thus far this year, which do not indicate complacency about inflation. In fact, in the February FOMC directive, I supported somewhat higher upper boundaries for the narrow aggregates than those adopted, in order to reduce the risk that the economy could slip into a growth recession.

My main reason for this view is that the velocities of those aggregates, the ratios of GNP to M1 and to M2 respectively, may grow more slowly than their historical trends. This would mean that faster money growth would be necessary to achieve an acceptable rate of economic growth; it does not mean taking one's eye off the danger of reinflation.

The megadeficits in our balance of trade and in our federal budget complicate the problem of forecasting velocity and thus money growth. If significant progress is made in reducing the budget deficit this year, interest rates might fall and this could further reduce velocity. Even if the budget deficit is not reduced substantially this year, a continued trade deficit and the associated inflow of foreign savings could put downward pressure on interest rates. Alternatively, if the dollar continues to fall as it has in recent weeks, this could begin to put some upward pressure on interest rates. There are too many uncertainties attached to the domestic and international situation to forecast interest rates with certainty and in turn to anticipate the impact of changing rates upon velocity. However, on balance, I would not be at all surprised to see flat or even slightly declining velocity for the year as a whole. Certainly the results for the first quarter have moved things in that direction.

Policy Implication

A prolonged decline in velocity would require a comparable period of rapid money growth to avoid an overly contractionary monetary policy. Thus M1 and M2 easily could have to exceed their upper boundaries in 1985. To illustrate this point consider one of many possible outcomes--a 7 percent increase in nominal income growth this year. If M1 and M2 velocities grow at their expected trend rates, this would require about 6 percent M1 growth, and M2 growth of about 7 percent. If, for example, interest rates are unchanged on balance over the year, the negative cyclical-velocity component coming from last year's interest rate declines would most likely hold M1 and M2 growth to somewhat above their respective 7 and 9 percent upper boundaries.

And this is precisely my point: such rapid monetary growth during a period of declining velocity and reasonably stable interest rates would not inevitably lead to a reacceleration of inflation. As I have said, the more rapid money growth would be necessary to counteract the contractionary effects on real GNP of weak velocity. The events following the 1982-83 surge in M1 support this point. Partly in response to a large decline in velocity in 1982 and early 1983--which in my view was in good measure a response to the decline in inflation and interest rates in 1982--the Fed permitted rapid M1 growth. Since then, money growth rates have been much more moderate, and there was no increase in inflation.

A decline in the income velocity of the narrow aggregate associated with the recent drop in interest rates or any possible future decline also would not imply permanent distortions in the money-to-income relationship. The distortion would occur only during a transition period, in which the public's demand to hold money would rise to a higher level, in response to interest rates falling to a lower level. It could take a year or so for this adjustment to be completed, after which V1 should resume more normal rates of growth, as in 1983-84.

We have what I consider a splendid opportunity to continue along a path of healthy economic growth, with low rates of inflation. There are some signs of somewhat faster expansion in the economies of our trading partners. However, greater convergence in fiscal and even monetary policies is still a goal to be further pursued. The interdependence of the global economy among both the developed as well as the developing nations demand no less. The opportunity for a prolonged period of growth is important enough to warrant exercising the flexibility in the conduct of national policies necessary to attain such a desirable end.