For Release on Delivery
2:00 p.m., E.D.T.
Wednesday, May 22, 1985

Issues for Longer-term Monetary Policy: Growth and International Capital Flows

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Presented at the

Congress of American Industry

National Association of Manufacturers

Washington, D.C.

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Today's less exuberant expansion has highlighted imbalances in our economy: lower capacity utilization, cutbacks in our industrial sector as it continues to be buffeted by foreign competition, and the high foreign exchange value of the dollar. Of course, not all sectors are negative: business capital formation is continuing, albeit at a slower rate, and the consumer may still be willing to go into debt and spend. But, on balance, economists are lowering their forecasts for real growth this year.

The slowdown in our economy redirects our attention to its long-run potential growth, which is so vital to material progress domestically and around the world. Growth is sluggish this year compared to last, but are we actually progressing below our potential? Just what is the long-run trend of economic growth that this economy is capable of sustaining? Seldom have we had such a wide variety of opinion on this question. Those with an historical bent suggest that our sustainable growth potential is only 2 to 3 percent per year. If that is true, then the last three quarters have been around the trend line. There are others who project figures as high as 4 to 5 percent. If they are correct, then our present mix of fiscal and monetary policy may be missing an opportunity for growth.

Some have argued that rapid growth would be a solution to the domestic-fiscal and international imbalances currently besetting the U.S. economy. They assert that the Federal Reserve could do a great deal to solve the problems of imbalances. Their prescription is a substantially easier monetary policy, which they assert would reduce real, or inflation-adjusted, interest rates and the exchange value of the dollar, and increase growth in the economy. These developments, should they occur, would help balance the federal budget, reduce the trade deficit, and permit a reversal to begin in the capital inflow from abroad. In short, then, the deceleration of real economic growth in 1985 together with the startling size of the domestic budget deficit and foreign capital inflows raise some questions about monetary-policy objectives over the longer term. What is the relationship between monetary policy, the budget deficit, and international capital flows? To what extent should monetary policy aim at correcting these international and domestic imbalances?

Economic Growth and Potential GNP

The appropriate answers to these questions depend importantly on the interpretation placed on the unusual configuration of the current economic recovery. Economic growth has occurred in the face of historically high real interest rates. On the basis of sample interview data, survey responses as to the expected real interest rate on 10-year Treasuries ranged from 4 to 7-plus percent in the current recovery, compared to a range of 1-1/2 to 2 percent in 1978-80. The strength of the dollar is another development that has surprised most analysts, with its trade-weighted foreign exchange value having increased by over 70 percent since 1980. The strong dollar is a major factor behind the unprecedented size of the U.S. current account deficit, which grew to over $100 billion in 1984, and the associated inflow of foreign capital. The federal budget deficit exploded to $200 billion in fiscal 1984, the largest in history. Finally, Federal Reserve monetary policy has been aimed at contributing to the solution of the inflation problem that developed in the 1970s: the inflation rate has fallen sharply from 9 percent in 1981 to 3-1/2 percent last year (measured by the GNP deflator).

Some analysts argue that, although such disinflation should be a major goal of monetary policy, the Federal Reserve has been overdoing a good thing in the past two years or so. According to this school of interpretation, which focuses on the potential growth rate of GNP, the configuration of events in this economic recovery is explained by a combination of the tax cuts in 1981 and other incentive-enhancing policies such as deregulation.

Has raising the incentives for saving and investment increased the so-called "potential," or long-run trend rate of growth in real GNP? There is no question that venture capital is back. The 1983-1984 investment boom, in part, reflects marginal tax-rate reductions. Potential GNP essentially is the supply of goods and services that the economy is capable of producing on a long-term basis. Those who believe that potential GNP growth is faster than before argue that, as a consequence, rapid actual GNP growth now is feasible on a sustained basis without reigniting inflation. In this view, today's monetary policy has not permitted real interest rates (and dollar-exchange rates) to fall to their natural, or equilibrium levels, and thereby has restricted GNP to unnecessarily slow rates of growth.

Even the high budget deficit, it is argued, has been caused by backward-looking monetary policy. Much lower interest rates would reduce the deficit via lower debt servicing, and much faster economic growth would enhance tax revenues. Thus, in this view of the world, a significantly easier monetary policy could contribute to a solution to the problems of the budget and trade deficits, and of high interest and exchange rates.

This policy prescription could have merit if the explanation of underlying events could be supported. Unfortunately, the available evidence raises serious doubts about the applicability of any theory requiring markedly easier monetary policy. But, as I indicated, this particular theory focuses on the growth rate of potential GNP.

Let us then examine the four components that contribute to this growth, which are the trend growth rates in: (1) population; (2) the percentage of the population that participates in the labor force (the participation rate); (3) the average number of hours the labor force works in a week (the workweek); and (4) productivity. The trends in these four factors define how rapidly the U.S. economy can produce goods and services on a sustained basis.

First, with respect to population growth, the Census projects a 1 percent growth rate in the working-age population in the years immediately ahead. As to participation rates, they will likely be somewhat below the 3/4 percent annual increment of the 1970s. Almost all of the upward movement in the last 20 years has resulted from higher participation by women. It is unlikely that this participation will continue to climb as in the past, since the demographic trends behind it, such as falling birth rates, have slowed. The trend rate of decline in the average workweek has been relatively stable over the past 3 decades. A reasonable guess is that the workweek will continue to fall at its historical average rate of about 1/4 percent per year.

Of course, the incentive effects of changes in marginal tax rates may cause increases in participation rates and the workweek. Lower tax rates, not to ignore "tax reform and simplification," could induce these effects, but this does not seem to have happened yet. In 1985, both the participation rate and the workweek are displaying typical cyclical behavior.

The strongest case for a higher growth in potential GNP today comes from productivity developments. There is a great mass of anecdotal evidence that companies are streamlining their management and staff structures, rationalizing work rules, introducing new, high-tech products into the production process, and generally becoming more efficient in the new environment of deregulation and international competition. Moreover, productivity has grown fairly rapidly over the past few years, especially when compared with the sluggishness of productivity in the 1970s. Over the past 2 years, nonfarm productivity has grown at rates of 3-3/4 and 2-1/2 percent, respectively, compared to a trend of about 1/2 to 1 percent in 1973-79.

Analytically, a good deal of the increase in productivity growth in recent years represents a normal cyclical response to the economic recovery. At present, private nonfarm productivity has grown by just about the average in five previous postwar cyclical upturns. However, more sophisticated econometric analysis of the trend and cycle components of productivity yield more promising results. This analysis suggests that the trend is around 1 to 2 percent in 1979-84. But this is considerably better than the subpar trend noted in 1973-79.

What does this mean for growth in potential GNP? If we relate the estimated growth rates of its four components, and include reasonable ranges for error, we come up with an estimate of 3 percent, plus or minus 1 percent. This result is consistent with the divergent views of the experts on this subject, and with my personal projection of a range of 3 to 4 percent real growth.

Of course, none of this analysis of (historical) data denies the possibility that the anecdotal evidence on productivity-enhancing measures by business will begin to show stronger results in the future. I will be surprised, in fact, if this does not occur. But this happy circumstance does not seem to have occurred yet, at least not in a dramatic fashion. Until it does, it would be a mistake for the Federal Reserve to assume that very rapid GNP growth could occur on a sustained basis without threatening progress on inflation. This is an error comparable to the "growth-means-inflation" syndrome on the other side of the debate. A more balanced view leads to better policy.

Fiscal/Monetary Mix

In my view, the most likely explanation for the configuration of developments in the current recovery centers on a combination of a highly expansionary fiscal policy and a disinflationary monetary policy. Increases in government spending and tax reductions in recent years have raised demands for goods and services. With Federal Reserve policy designed to prevent the economy from "overheating," real interest rates have had to rise, threatening to crowd out some spending in interest-sensitive sectors of the economy.

Expressed in terms of the credit markets, government has increased its demands for credit. This has raised real interest rates enough to crowd out the credit demands of some private sector spending; at the same time there have been increases in the pool of savings available to United States borrowers. Because of safe-haven characteristics, high real interest rates, and projections of robust future rates of economic growth, the foreign exchange value of the dollar has risen sharply and a record volume of foreign capital has poured in.

Could the Federal Reserve safely attempt to bring down short-term rates and stimulate much stronger economic growth in order to reduce budget deficits, absent fiscal policy leadership and support? Would massive money growth avail in foreign exchange markets without economic policy changes here and abroad? The answer to both questions is no. Such policies by the central bank would involve substantially reducing real interest rates in the U.S. below their natural, or equilibrium rates, which, in large part, are historically high because of the stimulus of fiscal policy. To reduce real interest rates in this way would set the stage for higher inflation in the future. Although excessively expansionary policies might have some transitory benefits, they obviously would not be a solution to present problems. The experience in the late 1970s and the early 1980s has taught us about the disruptive influence of high and variable inflation in the United States on the domestic and world economies. This experience also demonstrated the high costs for the economy of getting rid of inflation once it gains momentum.

Foreign perceptions that monetary policy will remain dedicated to disinflation are essential to investors as a protection of future real rates of return. Obviously, a decline in the dollar in response to high inflation would involve higher real interest rates domestically, and more crowding out of domestic spending. Given the size of the budget deficit, sustaining reasonable levels of domestic spending depends importantly on the availability of foreign capital, and therefore on the continued attractiveness of dollar-denominated assets to foreign investors.

Nor is there is any real trade off between domestic and world economic considerations that can be exploited by monetary policy. Highly expansionary monetary policy could temporarily bring down short-term interest rates and exchange rates, but it could raise the long-term interest rates attractive to foreign investors. This is another aspect of the general conclusion that while monetary policy goals for the long-run have to be framed with due consideration of foreign capital flows, the strength of the dollar, and international trade imbalances, Federal Reserve policy should not focus so much on these problems that it runs the risk of reigniting inflation. Of course, it should be recognized that, even with a favorable inflation outlook, we cannot indefinitely count on such large amounts of foreign capital to sustain domestic spending. Eventually, foreign investment portfolios will become saturated with dollar-denominated assets, and the inflow of capital from abroad will wane.

These considerations demonstrate how essential it is that progress be made in correcting domestic imbalances, and their international counterparts. But major progress will have to await action on policies not under the authority of the Federal Reserve. Efforts in this regard are proceeding. Congress currently is making notable progress in putting together a deficit reduction package; the prospect of high-level trade liberalization talks was raised at the recent economic summit in Bonn; and the central banks of several industrialized countries showed an increased willingness earlier this year to intervene in the foreign exchange markets in an attempt to head off strengthening of the dollar.

I am personally not optimistic about our ability to use market intervention to move exchange rates materially below levels determined by fundamental economic factors. Although intervention in recent months may have had a marginal impact on the dollar by braking a certain degree of speculative psychology, the decline in the dollar since February probably was related mainly to more fundamental factors--for example, prospects for lower real interest rates in response to weaker economic growth and improved chances of reducing the budget deficit. Similarly, although there are potential benefits from opening up foreign markets to U.S. products and financial services, fundamentally the trade deficit is likely to persist as long as the foreign exchange value of the dollar remains so high. It is with special interest that I follow the drama unfolding in the Congress over the budget bill, since progress at reducing the deficit offers the promise of a real solution to current domestic and international imbalances. The recent actions by the Senate and the House Budget Committee are encouraging, but the Congress still has a long way to go before a final budget is passed.

What Can the Fed Do?

During the interim, while other solutions are being worked out, what contribution can the Fed make to correcting imbalances? The optimum objective for the Federal Reserve is to foster a so-called soft landing for the economy--with real GNP growing somewhat toward the upper range of its potential rate, so that the excessive unemployment rate can decline gradually, and the inflation rate can also decline gradually or at least not rise. However, the Federal Reserve can contribute to dealing with the imbalances by guarding against the possibility that the economy might slip into an extended period of sluggish growth, as it has over the past nine months.

The factors that contribute to the underlying rate of inflation look reasonably favorable. Trends in wages and productivity seem to fit that description, as do measures of slack in the labor and capital markets--the unemployment and capacity utilization rates, including those measures related to our trading partners. Similarly, commodity prices have been declining for some time now, and producer prices have been relatively flat. Apparently it would take a precipitous dollar decline to cause major U.S. inflation problems. Foreign suppliers are likely to absorb declines in the dollar in the short-run to hold market share. The main point is that although the inflation picture is imperfect, it has improved enough to afford latitude in the conduct of monetary policy. Historically, given the uncertainties about the lags in monetary policy, it has not been possible to tell for sure if an economic slowdown is simply a pause before the stimulating effects of lower interest rates and faster money growth take effect, or whether it indicates an attenuated period of inadequate expansion.

Over the long run, flexible monetary policy implementation, in turn, is desirable from the standpoint of making further progress against unemployment. And more to the point, the approach also avoids exacerbating the problem with the budget deficit and international imbalance. Slow growth raises the deficit, and indirectly increases the pressure for foreign capital to be made available in the U.S. and for the associated trade deficit. Although, as I said, it would be a mistake for the Fed to aim at trying to achieve a major contribution to balancing the budget through excessively high real economic growth, it also obviously would be a mistake to exacerbate these problems by permitting sluggish GNP growth to persist.

At the same time, the Federal Reserve today must be particularly watchful for changes in the long-run potential growth of the U.S. economy. The longer-term growth of the monetary aggregates should be adjusted to facilitate a rate of economic growth which is sustainable in the long-run without inflationary pressures. Today's evidence does point to rates of economic growth above those of the 1970s, but not yet in line with the most optimistic projections. Nevertheless, progress to date at reducing marginal tax rates, the spread of deregulation in the economy, and technological progress may already have set in motion forces that will enhance the potential growth of our economy in the future. Continued progress in the Congress toward expenditure control and toward tax reform that should further increase incentives to invest, save, and work is vital to achieving significantly higher growth rates. Monetary policy should play a complementary role to fiscal policy in this respect, once it is evident that the economy is capable of sustaining a more rapid pace of expansion.