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The Economic Climate in the United States Today

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We are now in the third year of an economic expansion that has been in the doldrums for four quarters. Sluggish growth has been accompanied by a sharp acceleration in the monetary aggregates and an easing of interest rates. Despite a generally accommodative monetary policy, developments in the "real" economy have led some observers to conclude that economic expansion has begun to burn itself out. Others, who focus on monetary developments, particularly upon the narrow monetary measure, conclude that we are in for a major rebound in the third or fourth quarter, setting the stage for another round of reinflation. The middle majority of forecasters expect the economy to stay in a less dramatic ground between the two extremes. I find myself somewhat aligned with those in the middle, although there are to me major downside risks affecting the economy.

I plan to lay out my views on the outlook for the economy in the context of the recent re-evaluation of the 1985 monetary target ranges by the Federal Reserve. As I see it, the most likely outcome for the economy over the next year or two is for sustainable growth without renewed inflationary pressures. But in order for this economic path to be realized and the risks to be managed, it must be supported by a flexible approach to monetary policy by the Federal Reserve. As always, there is considerable room for uncertainty about the outlook. Three areas of uncertainty will be highlighted -- consumption and consumer debt; housing and office construction; and trade protectionism.

Inflation

In the United States, inflation has been relatively well contained for 3-1/2 years, with the GNP-implicit deflator averaging about 4 percent. Most of the important inflation factors suggest the possibility of further disinflation -- of some additional moderation in the rate of price increases.

Indices of commodity prices have fallen substantially since early 1984. More recently, prices of crude petroleum have been declining rather sharply, and the prospects for further declines seem good. Wage increases have moderated significantly, and in view of recent union contracts, are likely to continue to do so.

Growth in productivity appears to have moved to a somewhat higher trend than the sluggish performance of the 1970s, despite the very large increases in employment in this economic expansion. I have been disappointed that productivity has not grown even more rapidly, but at least the moderate increase has helped to attenuate inflation. I still am optimistic that in the not-too-distant future the improvements in corporate-management structure and the increased use of high-technology equipment will overcome payroll growth and begin to translate into faster productivity gains.

The degree of slack in labor and capital markets also suggests that currently there is not a clear-and-present danger of a re-acceleration of inflation. Industrial capacity utilization has declined gradually over the past three quarters, and appears to stand below its "full" utilization rate. The unemployment rate has been "stuck" at a 7-1/4 to 7-1/2 percent rate for over a year now, and shows no signs of reaching levels that could be reasonably considered full employment. About 8.5 million persons were jobless in the United States at last count.

Surveys suggest that inflationary expectations have stabilized over the past year at relatively moderate rates when compared with the early part of the 1980s. Moreover, the Federal Reserve's credibility as an inflation fighter appears to have been strengthened during the contemporary period of disinflation. Of course, credibility must not only be earned but reearned through policies which yield results.

Uncertainties about the future foreign exchange value of the dollar are a possible cloud over the inflation horizon. By mid-August the dollar had fallen about 15 percent from its peak in February of this year, and some analysts are arguing that a falling dollar could raise inflation in the United States. I agree that a precipitous fall, were that to occur, could raise U.S. import prices for several years, although of course it would not affect the underlying inflation rate. There is no compelling reason at present to <u>expect</u> such a decline. However, given the difficulties forecasters encountered in anticipating the huge appreciation of the dollar in the 1980s, one certainly cannot confidently assess predictions.

Moreover, in my view, continued declines at a moderate pace would not be likely to have a large short-run effect on inflation. Based on historical relationships, a rule of thumb is that a 10 percent depreciation of the dollar would raise the level of consumer prices by 1-1/2 percent by the end of 3 years. But I would expect the effect to be much smaller initially this time around because profit margins are unusually wide for many foreign firms that compete for market shares in the United States, and they are not likely to easily give up the market shares they have captured.

The Economy

I would characterize the economy over the past year as being in a "grey zone" between healthy, sustainable growth and a growth recession. As you know, real GNP has advanced at only a 2 percent rate over the past four quarters, below even conservative estimates of the potential, or sustainable, rate of growth for the U.S. economy. There is some room for optimism that a healthier rate of growth could prevail in the future if we escape downward pressures on the real economy and financial setbacks. Over the next year and a half, the economy could experience rates of growth moving toward its long-run potential.

As I view it, this prospect is based mainly on the substantial decline in interest rates over the past year or so, as well as the flexible approach to monetary targeting employed by the Federal Reserve when it accommodated the recent surge in M1 growth in its mid-year re-evaluation of monetary target ranges. Short-term interest rates have declined by around 350 basis points since the middle of last year, and long-term yields have fallen by only slightly less. The narrow monetary aggregate, M1, has accelerated to more than 10 percent rates of growth in the first two quarters of this year and has continued to grow rapidly in the current quarter. These developments suggest that in the future we could see more strength in the interest-sensitive sectors of the economy.

Recent sluggish growth and disinflation make the case for a flexible approach to be used by the Federal Reserve in supporting the economy. Moreover, financial institutions, instruments and markets continue to evolve broadly and rapidly, and the information content in the monetary aggregates, though useful in past periods, warrants careful analysis and interpretation. As you can see, I differ with some commentators, such as Milton Friedman in a recent Wall Street Journal article, who argued that the Federal Reserve should rigidly adhere to pre-announced monetary targets. I believe that effective monetary policy requires more judgment and flexibility.

In my view, this judgment was sensibly and responsibly exercised in our recent policy decisions, discussed in the July 1985 Congressional testimony pursuant to Humphrey-Hawkins. Our decisions about monetary policy through 1986 included the so-called rebasing of the 1985 target range for M1. That aggregate grew at a 10-1/2 percent rate in the period from the fourth quarter of last year to the second quarter of this year, compared with an original target range of 4 to 7 percent. Our response was to accommodate this rapid growth by establishing a new, wider target range for 1985 of 3 to 8 percent beginning from the high second quarter base level.

This action was taken against a background of large declines in the velocity of money -- the ratio of nominal GNP to M1. With nominal GNP rising at only a 5 percent rate in the first half of this year, despite 10-1/2 percent M1 growth, the velocity of M1 declined at a 5-1/2 percent rate. Obviously this is a substantial drop for a variable that had a 3 percent upward trend in the 1960s and 1970s.

However, this is not the first time that velocity has dropped sharply. It also did so in 1982 and the first half of 1983 -- over those six quarters it fell at a 4-1/2 percent rate. Then rapid M1 growth of 9-1/2 percent produced nominal GNP growth of only 5 percent. Although the exact causes are still the subject of some debate, in my view a large part of this velocity decline was due to the sharp drop in market interest rates and in inflation in 1982. When market interest rates fall, individuals and businesses tend to hold larger M1 balances because the interest they must sacrifice is less. Analysis of past experience suggests that the drop in interest rates can explain a significant part of the rapid M1 growth.

Moreover, it appears to me that the interest rate decline in 1982 had only a small stimulatory effect on GNP because inflation also declined by about the same amount, leaving real (or inflation-adjusted) interest rates little changed on balance. Thus in large part, velocity appears to have fallen in 1982-83 because there was a sharp decline in market interest rates that stimulated M1 growth, whereas there was little or no decline in real interest rates to stimulate GNP growth. Another possible factor in the 1982-83 velocity decline was an increase in precautionary holdings of money as households and organizations reacted to the two periods of recession about that time. Absent foreign exchange market complications, these velocity conditions imply some accommodation of rapid money growth as was done when the Federal Reserve rebased M1 at the second quarter of 1983. This rebasing was followed by a strong economic recovery and no reacceleration of inflation.

The situation this year appears to be much more complicated and difficult, having some elements in common with 1982-83 and some elements that are unique. One element in common is that much of the rapid M1 growth this year appears to have been stimulated by the drop in market interest rates since the middle of 1984. One difference from 1982-83 is that there appears to have been only a slight fall in inflation over the past year -- in other words, real interest rates fell along with nominal rates.

Why then has this not had a more strongly stimulatory effect on GNP? One possibility is that interest rates may have fallen in large measure because of weak aggregate demand for domestically produced goods and services due to the unprecedented growth of imports relative to exports in this country. Put differently, a major reason for high real interest rates in the United States appears to have been the demand put on the credit markets by the financing requirements of the huge federal budget deficits. But over time, this effect on interest rates is likely to be increasingly offset by an inflow of savings from abroad. When this occurs, through a deteriorating United

States current account balance, real interest rates could fall to more-or-less "permanently" lower levels, and so could velocity. In order to keep the recovery going, such "permanent" velocity declines must be offset by an accommodation in more rapid money growth. Such an accommodation was accomplished by the rebasing of the M1 target range to the second quarter of this year.

Another consideration possibly supporting rebasing in 1985 is the anecdotal information suggesting that M1-type accounts may have been accumulated in response to scattered incidents in the financial system: the Ohio and Maryland thrift situations, secondary bond dealers in New York, and agricultural credit institutions are cited. However, no firm conclusions emerge from this discussion -- financial difficulties have been ameliorated by the actions of management, of state and federal regulatory bodies, and by the responsible actions of state legislatures in Ohio and Maryland.

Some analysts have argued that disinflation has induced a change in behavior and attitude by individuals and businesses away from tangible assets toward liquidity. This hypothesis assumes that, for some, the inflation-hedging motivations of the 1970s have given way to precautionary ones in the 1980s, and that the efforts to reliquify balance sheets, both business and personal, constitute new forces in financial markets. It may be that liquid assets in M2 are influenced by these considerations. At best the evidence supporting this argument is sketchy, but the possibility of some changes in behavior, at the margin, cannot be totally ignored.

Information derived from the monetary aggregates has served monetary policy well over much of the past decade. Over long enough time periods it is certainly true that "money matters," and that rebasing M1 in 1985 was clearly preferable to simply deemphasizing M1 for some indefinite period of time. The velocity of the narrow monetary aggregate is likely to return to a more predictable trend line once the impacts of changed instruments and institutions, including international institutions, diminishes, and once interest rates have finished adjusting to inflows of foreign savings and to disinflation.

Some Uncertainties About the Outlook

I have just given my reasons for cautious expectations of a return to somewhat more healthy growth in the United States economy. But, at the same time, I am acutely aware that at this point in time, it is difficult to see much resurgence in the data for the current quarter. It is important to keep in mind that the exact timing of the responses of the economy to interest rates and money growth always has been highly uncertain, and it is possible that more strength may show up later on. In light of this uncertainty, the current approach to monetary policy provides the Federal Reserve with the flexibility to react appropriately to the economic conditions that emerge.

It will come as no surprise to you that I am concerned about a number of specific uncertainties in my outlook that could possibly present policy choices to the Federal Reserve in the future. As I mentioned at the outset, there appear to me to be substantial downside risks for this sluggish economy, and I would like to conclude my talk today by discussing some risks that I think are especially important.

A number of analysts have expressed concern about the possible constraining effects of rising consumer debt on the outlook for consumption expenditures. Household debt as a percent of disposable personal income recently has reached an all-time high of over 75 percent. Moreover, consumer debt has grown faster than consumer assets for about two years. This debt is especially burdensome because (real) consumer borrowing rates are at historically high levels. This issue obviously is a crucial one for the economic outlook, since over the past two and one-half years consumption spending accounted for over 65 percent of the increase in real GNP.

Although debt levels do raise serious questions about the sustainability of continued strength in consumption, there are some factors that appear to make the situation somewhat less worrisome. First, deregulation of financial markets has made increased interest income available to many consumers, helping some to offset the burden of high interest expenses. Second, the expanding use of credit cards for their convenience rather than for borrowing has biased upward measures of consumer debt in recent years. Third, the expansion of outstanding consumer installment debt is consistent with historical relationships between borrowing and consumption, on the one hand, and debt repayment and the outstanding stock of debt, on the other hand. Finally, consumers are coping with debt. Delinquencies have risen only slightly so far in this expansion. But despite these mitigating factors, the consumer debt situation is one that bears watching.

The mortgage debt situation is especially worrisome. Home mortgage foreclosures and slowness of repayment are currently at high levels. Home prices have fallen in some areas. The home mortgage insurance industry is incurring foreclosure losses several times historical levels. In two instances, potential losses associated with the huge mortgage-backed security market have cast a shadow on that source of funding. Lenders, mortgage insurers, the Federal National Mortgage Association and Standard and Poor's have tightened underwriting standards.

These "credit" developments threaten to overcome the otherwise stimulative effect of the drop in mortgage interest rates, particularly adjustable rates. Since July of last year, interest rates on conventional mortgages have fallen by a substantial 2-1/2 percentage points, although if one goes back to February 1984 for a point of comparison, the decline is only about 1 percentage point. These declines could make positive contributions to housing-construction activity during the next year or so, although this strength has yet to show itself.

There appears to be a more substantial risk of a sudden drop off in multi-family and office building. Construction in both of these areas, but especially offices, has proceeded at a rapid pace despite high and rising vacancy rates. Much of this can be attributed to a favorable tax environment. But rising vacancy rates cannot be sustained forever, and I fear that spending in these areas could be reversed.

When discussing risks these days, it always is necessary to give prominent mention to the international debt and trade situations. The dangers for the economies of the world and for the servicing of the debt of less developed countries from a sudden surge of protectionist legislation are so well known that they do not need to be spelled out. One must recognize the unlikely, but not impossible, circumstance in which a trade war could seriously hamper world production. In my view, the four quarters of sluggish U.S. growth have contributed to protectionist pressures. Unemployment has remained stubbornly above its natural rate and, against this background, the closing of plants and the layoffs in import-impacted industries have appeared all the more onerous.

In summary, I have argued that the outlook for the economy has been enhanced by the recent rebasing of the M1 target range for the latter half of this year. This flexibility to support the economy is possible in large measure because of favorable inflation factors at the present time. While the overall outlook is fairly good, there are a number of risks that could come into play and present the Federal Reserve with further difficult policy choices in the future. This discussion serves to illustrate the general point that effective monetary policy requires the continual application of sound judgment and prompt responses to financial and real economic developments in both the domestic and international spheres.