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THE OUTLOOK FOR ECONOMIC EXPANSION IN 1984

Remarks by

Lyle E. Gramley

Member, Board of Governors of the Federal Reserve System

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THE OUTLOOK FOR ECONOMIC EXPANSION IN 1984

My role in the program today is to discuss the prospects for continued economic expansion in 1984. I cannot adequately do so without at least mentioning two subjects to be addressed by the other speakers--namely, the present course of fiscal policy and the role that financial variables may play in shaping economic developments this year. But I promise to say no more about those subjects than is essential to my topic.

I will also succumb to the temptation to say a few words about monetary policy--a sin for which I will probably be more readily forgiven. Let me make it clear, however, that my remarks represent strictly a personal point of view, not an expression of Federal Reserve Board opinion.

For openers, let me review just briefly the progress of the recovery to date. You will remember that, in late 1982, most forecasters expected the first year of recovery to be quite weak. High real interest rates were expected to dampen domestic demand, while the position of the dollar in exchange markets and the weakness of recovery abroad would hold down the demand for exports.

In fact, the recovery thus far has been relatively normal in terms of both the sources of stimulus and the speed of advance. As usual, an upturn in housing, a turnaround in inventory investment, and a strong rise in personal consumption expenditures were the main driving forces. Growth of real GNP over the four quarters of 1983 did, if estimates for the fourth quarter are correct, fall a bit short of the average for the first year of previous postwar recoveries. Nonetheless, with the labor force increasing slowly, the drop in the unemployment rate was one of the fastest for the comparable period of any postwar recovery.

One argument should have been laid to rest by the performance of the economy over the past year--namely, that high levels of real interest rates would inevitably prevent vigorous economic expansion. That has obviously not been the case to date, perhaps in part because fiscal policy is highly stimulative. That is a lesson that influences my own views on growth prospects for 1984.

Just a few words regarding developments to date on the inflation front. So far, price and wage developments have been encouraging, but nonetheless leave some cause for concern. Early last year, wage rate increases moderated further, especially in the blue collar area, and relatively good gains in productivity also helped to hold down costs. For the year as a whole, the fixed-weight GNP deflator showed no acceleration--rising at an annual rate of 4-1/4 percent. But progress in reducing the rise of wage rates appears to have ended in the second half of 1983, and the "flash" estimate of real GNP growth for the fourth quarter implies that productivity gains came to an end, at least temporarily. Moreover, the rise in the CPI during the six months ended in November, at a 4-1/2 percent annual rate, compares with a two percent rate in the prior six months. This fact suggests that businesses took advantage of improved product markets to widen their profit margins.

Where are we likely to go in 1984? A strong consensus is developing among major professional forecasters that growth over the four quarters of this year will slow to between four and five percent, with a substantial number of forecasts clustering around the midpoint of that range.

Growth of that magnitude is expected to reduce the unemployment rate to 7-3/4 percent by year end, assuming resumption this year of more normal rates of growth of the labor force.

Housing is not expected to add much to overall expansion in 1984, and the rise in personal consumption expenditures is most unlikely to equal the 1983 advance. More important, the turnaround in nonfarm inventory investment, from deep liquidation to moderate accumulation, amounted to 2-1/4 percent of real GNP over the four quarters of last year. Some further rise of inventory investment may occur in 1984, but much less than in 1983. Offsets to those waning sources of stimulus are expected from a continued increase in defense outlays, a continued strong rise of business capital outlays, and an end to the decline in real net exports of goods and services that has been underway since late 1980.

Most forecasters expect the inflation rate to creep up to the five to six percent range during the second year of recovery, stemming partly from the higher increases in wage rates, reduced productivity gains, and efforts to widen profit margins that not infrequently occur in the second year of a business expansion. Increasing food prices and a rise in social security tax rates also are likely to add to cost and price pressures.

The consensus forecast thus has nominal GNP rising around nine to ten percent over the four quarters of 1984. While real growth may slow somewhat as the year progresses, price pressures may be somewhat stronger in the second half, so that nine to ten percent increases in nominal GNP might well persist throughout the year.

The consensus forecast seems to me an eminently reasonable one--as a starting point. But we need to ask ourselves two questions. First, what is most likely to go wrong, and where do the risks lie? Second, in light of the answer to the first question, what is the appropriate course of monetary and fiscal policy during 1984?

A small, but relatively cohesive, group of forecasters is concerned that economic growth may slow substantially in the first half of this year--and perhaps even turn negative--because of the recent sluggish growth of M1. Such a judgment strikes me as at variance with the signals being cast off by most major nonfinancial indicators, which point to continued expansion in the near term.

In interpreting the behavior of money balances, one needs to remember that what we observe is not a pure money supply phenomenon, but the intersection of money demand and money supply. If interest rates were rising rapidly, or if nominal GNP growth were slowing markedly, the recent slowdown of M1 growth might be reflecting restraint of money supply. Neither of these two things is happening, however, suggesting that what we are observing is a pronounced rise in M1 velocity stemming from weakness, perhaps temporary weakness, of money demand.

To put the matter differently, the day-to-day methods of implementing monetary policy currently employed permit the demand for money balances to play a rather heavy role in determining the growth of money in the short-run--a substantially heavier role than was permitted with the methods employed from October 1979 to October 1982. Had the demand for M1 balances been more robust during the late summer and fall months of 1983, the stock of M1 would have increased more rapidly.

In any event, it is well to keep in mind the fact that forecasts based on the behavior of M1 alone have been wide of the mark during the past two years. For example, the Board's staff maintains a version of the well-known St. Louis Federal Reserve Bank reduced-form model of the economy. Simulated dynamically, using as initial conditions those prevailing in the fourth quarter of 1981, that model predicts recovery beginning in the first quarter of 1982 (one year early), and stronger-than-actual growth in 1983. By the fourth quarter of last year, the predicted level of real GNP exceeds the actual by 6-1/2 percent, a huge error by almost anyone's standards. The rate of inflation predicted by the model over the two years exceeds actual experience by 1-3/4 percentage points at an annual rate. As a consequence of errors on both the real and the price side, the predicted level of nominal GNP drifts away from the actual level over an eight quarter period by ten percent.

These huge forecast errors are merely the other side of a coin labelled: "unprecedented behavior of M1 velocity." At no time in the postwar period have we seen such striking divergence of M1 velocity from its longer-term trend as we saw in 1982 and early 1983. The source of these unusual changes in velocity are not well understood, but they probably stem in some measure from changes in the composition of money balances.

In an attempt to make more sense of the money numbers, some financial economists have constructed what they term an "adjusted M1" series. A money demand function is fit to data prior to mid-1974, when the demand for money was more predictable than it has been since then. The demand function is then simulated, using actual levels of nominal GNP and interest rates, and predicted changes in money balances are used as substitutes for actual changes.

This is not an exercise that is very satisfying intellectually, but it does yield some interesting results. It suggests that "adjusted M1" has grown at an annual rate of something like six to eight percent during the past two years, and continued to increase at about that rate in the fourth quarter of 1983. There is no implication in these estimates of impending economic weakness, due to monetary restraint, in early 1984.

I do not think we at the Federal Reserve should take the actual behavior of money lightly, particularly changes over protracted periods. But in my judgment, adding more to reserve balances now in a deliberate effort to ensure more rapid growth of M1, and thus forestall the economic slowdown that some foresee, would be a serious mistake.

A second expressed concern about the solidity of recovery in 1984 stems from worries that large Federal budget deficits, combined with a disciplined monetary policy, will push up real interest rates enough to tip the economy into recession at some point. I fully agree with those who argue that fiscal stimulus puts upward pressure on real interest rates. But I also agree with mainstream economic thinking, which says that fiscal stimulus is expansionary. Other things equal, fiscal stimulus leads to more, not less, growth in nominal GNP. And more growth in nominal GNP, in the short run, typically means both more real growth and higher inflation.

The posture of fiscal policy embodied in current law poses a very serious future threat to the economy and to financial markets, a subject to which I will return briefly later. But I see no great danger that any upward pressure on interest rates will abort the recovery in 1984.

The principal risks for 1984, as I see them, lie in the possibility that aggregate demand may prove to be stronger than is contained in the consensus forecast. The economy entered the new year moving ahead strongly. Consumers are in a confident mood, and are spending rather freely. Retailers apparently are optimistic about the future of sales. Inventory/sales ratios, in real terms, have declined to levels that are lower than at any time during the past five years, and this might lead to significant further increases in inventory investment during 1984. The housing market seems to have shaken off the effects of the earlier rise in interest rates: sales of new homes increased from September through November, and housing starts and permits also recovered late last year. Business fixed investment (in real terms) grew at an annual rate of sixteen percent in the last half of 1983, and may continue to increase robustly in 1984 in response to rising profits and cash flow. Fiscal policy will still be adding stimulus to expansion: the structural deficit in the Federal budget, evaluated at a six percent unemployment rate, already amounts to 3-1/4 percent of GNP, and will increase further during 1984.

Continuation of a stronger-than-expected pace of recovery in 1984 would create a danger that inflationary pressures could worsen significantly. Any upturn in inflation would be unwelcome, since it would call into question the permanence of the gains against inflation won during recent years at very high cost. And if the acceleration in inflation proved to be greater than what the consensus forecast anticipates, the economy would be heading into 1985 with an inflationary momentum that would be difficult and costly to dispel.

What does such an outlook for economic growth and inflation imply for monetary policy? The Federal Reserve should, I believe, permit sufficient growth in money and credit to encourage sustained recovery. Unemployment of labor and capital resources is still high, and further expansion of the economy at a pace greater than potential growth is needed. Continued expansion of the U.S. economy also is essential to the health of the world economy. The Federal Reserve's tentative 1984 targets for money and credit growth, announced last July, are--in my personal judgment--adequate to finance the kind of recovery that is needed, barring unusual velocity developments.

The more important task for the Federal Reserve in 1984, it seems to me, is to return to the basic long-run objective of monetary policy established in late 1979--namely, to reduce gradually the growth of money and credit in order to bring an end to inflation. The objective of fostering recovery in the U.S. economy has been accomplished without renewing pressures on costs and prices or rekindling inflationary expectations. Nevertheless, the growth rates of the major monetary and credit aggregates since the middle of 1982--however adjusted--have been, from my viewpoint, uncomfortably high. And unless unusually large increases in velocity occur in 1984, the growth of nominal GNP contemplated in the consensus forecast, at present levels of interest rates, might require continued increases in money and credit above those consistent with a further reduction of inflation over the long-run.

If the Federal Reserve pursues a disciplined course of monetary policy in 1984, as I believe it will, serious conflict is threatened with the increasingly stimulative fiscal policy embodied in current law. Time for resolving this conflict is growing short. High levels of real interest rates have not prevented robust recovery, but they have already produced worrisome imbalances in the domestic economy and in international financial markets--export markets for U.S. goods that are weakened by an inflated international value of the dollar; unnecessarily heavy interest burdens for countries with large external debts, for young homeowners, and countless small business firms here at home; many thrift institutions operating with thin financial margins. Such imbalances would become increasingly severe if interest rates were to increase further.

Perhaps we will be fortunate enough to avoid any significant rise in interest rates during the current economic recovery. Cyclical history does not, however, hold out much hope for such an outcome--even when the Federal budget deficit declines as recovery proceeds, as has usually been the case.

Let me close by summing up my conclusions briefly. The current year should be a fairly good one for the economy. Real growth is likely to remain fairly strong, and further progress will be made in reducing unemployment. Prices may rise somewhat faster than in 1983, but with good fortune, and good economic policies, a serious rekindling of inflation can be avoided.

The fiscal and monetary policy choices made during 1984, however, will be crucial to the health of the economy in 1985 and beyond. During the past couple of years, economic policies have been quite stimulative, and a continuation of that situation during 1984 would risk a renewal of pressures on costs and prices and a return to more inflationary expectations. I know of no reason for thinking that the necessary dampening of aggregate demand should come from adjusting the throttle on one instrument of policy but not the other. Discipline in both fiscal and monetary policies would provide the greatest assurance of realizing the opportunities presently at hand of establishing the basis for a durable prosperity.

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