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Address

by

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"U.S. Monetary Policy and Prospects
for Sustainable Economic Growth"

It is a pleasure to be here this afternoon to address members of the Eastern Economic Association. I have participated in previous Eastern meetings and it is always enjoyable talking to fellow economists.

U.S. Monetary Policy

This afternoon I would like to talk about U.S. monetary policy and its role among broader policies for sustained worldwide expansion. Now is an especially convenient time to talk about this subject since just two weeks ago the Federal Reserve submitted to Congress its semi-annual report on monetary policy.

In this report, we reiterated our commitment to foster price stability. This commitment is significant not only as an end unto itself but because it is a necessary condition for other important goals; namely promoting sustainable growth in output and contributing to a balanced pattern of international transactions.

As I am sure you all are well aware, decisions made by the Federal Open Market Committee regarding money and credit targets for

1987 were also disclosed in this report. In particular, the Committee established target ranges for M2 and M3 of 5-1/2 to 8-1/2 percent from the fourth quarter of 1986 to the fourth quarter of 1987. These ranges for M2 and M3 are one-half percentage point below those in effect for 1986, and are below the actual growth rates last year. Therefore, they are consistent with the belief that a reduction in the growth of money supply measures, over time, will be needed if the economy is to achieve noninflationary growth and external equilibrium.

The FOMC elected not to establish a specific target range for M1 at this time because of uncertainties about its underlying relationship to the behavior of the economy. More specifically, the demand for money has been rather erratic and unpredictable. For example, the velocity of M1 dropped 9-1/2 percent last year, following a decline of 5 percent in 1985. Remarkably, since 1981, velocity has fallen 16 percent. This contrasts sharply with its trend increase of about 3 percent per year over the previous two decades.

There are several explanations for this unusual behavior of velocity. With the deregulation of deposit rates, and the attendant changes in composition, M1 has become much more responsive in the short-run to changes in interest rates, and possibly to other factors affecting the portfolio decisions of households. Accordingly, the combination of deregulation, continued disinflation and lower interest rates has interacted to alter M1 velocity. Only with the passage of time will it become possible to assess with any precision the longer-term trend growth of M1 relative to GNP. And only then will it be possible to make a judgement about its usefulness as an intermediate target of monetary policy.

It should be noted that the FOMC decision regarding M1 does not mark the total abandonment of this aggregate. Rather, the Committee will continue to monitor M1 behavior carefully, assessing its growth in the context of other financial and economic developments. And depending on circumstances, it is possible that at some time in the year the Committee might set more specific objectives for this aggregate.

Currently, however, the broader aggregates along with a careful monitoring and assessment of information provided by various financial auction markets seem more appropriate as guides for policy. For example, evidence of inflationary expectations signaled in the foreign exchange, bond, money, and commodity markets seems most relevant in this regard.

The Economic Setting

Before discussing the role of U.S. monetary policy in the context of other policies for sustained expansion, a brief review of the current economic setting seems appropriate.

The U.S. economic expansion is now extending into its fifth year and is already among the longest in peacetime history. While the overall rate of economic growth has been rather modest since mid-1984, averaging about 2-1/2 percent a year, that growth has been sufficient to create about 7 million new jobs during this period.

At the same time, inflation has continued to moderate as further progress has been made toward the objective of overall price

stability. Running counter to past cyclical patterns, labor cost pressures have also remained subdued. And also counter to past cyclical patterns, both the inflation rate and interest rates, after four years of expansion, are substantially lower than when the recovery started.

As inflation and expectations of inflation moderated last year, the Federal Reserve was able to supply additional reserves for the banking system and reduce the discount rate four times, by a total of 2 percentage points.

I believe that this combination of a lengthy and sustained expansion with a continued reduction in both inflation and long as well as short-term interest rates is at least in part a confirmation of sound policies undertaken by the Federal Reserve.

As we all know, however, the current economic setting is not problem free. There are important risks facing a continued stable expansion. Important trade imbalances exist with many of our principal industrial trading partners. These imbalances are due in part from

relatively more rapid growth in the U.S. economy combined with more attractive investment opportunities here. This combination produced capital inflows, dollar appreciation, and consequently a large trade deficit.

While such trade imbalances are not likely to be indefinitely sustainable, "quick fix" solutions to the problem such as fostering excessive dollar depreciation or protectionist trade legislation seem particularly inappropriate. What is important is that we attempt to maintain healthy returns to capital and adopt policies encouraging genuine economic growth. This approach fosters the wherewithal to finance the trade deficit and allows for its gradual resolution over time.

But trade imbalances are not the only risks currently threatening sustained economic expansion. In particular, large persistent Federal budget deficits and the protracted debt problems of less developed countries also remain important concerns.

Five Major Ingredients for Sustained Worldwide Expansion

In discussing prospects for continued expansion, several ingredients should be considered.

First, as suggested earlier, price stability is important not only in and of itself but because it is a necessary condition for the achievement of virtually all other important ingredients. Accordingly, disinflationary monetary policy should continue to be the fundamental policy objective of the Federal Reserve.

Secondly, a more stable and sustainable alignment of exchange rates is needed for long-term growth. Certainly, we are nearer to achieving this goal. An adjustment from the elevated dollar exchange rate levels of February 1985 was clearly desirable. Moreover, economic expansion in the U.S. has moderated relative to economic growth elsewhere in the world. And industrial country differences in both inflation and expectations of inflation have generally narrowed -- in part because of the adoption of somewhat more consistent, more coordinated monetary policies. This improved coordination has enabled interest

rate differentials to converge. Of course, the Plaza Accord and recent G-6 agreement have certainly contributed to the coordination of or rather the adoption of more consistent monetary and fiscal policies. And, consistency has bolstered the move toward a more stable alignment of exchange rates.

Thirdly, the U.S. must get its fiscal house in order. In particular, excessive Federal government spending and the associated large budget deficits must be brought under control. These spending habits together with the severity of the 1981-82 recession worked to dramatically enlarge the budget deficit and saddle the economy with huge public sector borrowing needs. Fortunately, a substantial improvement in the U.S. tax structure together with a disinflationary monetary policy made investment more attractive in the U.S. than elsewhere. Thus, so far, the resulting net capital inflows have supplemented domestic saving enough to finance both private investment and the Federal budget deficit without putting upward pressure on interest rates.

This situation, however, cannot continue indefinitely. Sooner or later progress must be made in controlling excessive Federal spending. Some signs do exist that progress will be made on this score. In particular, projections and some preliminary data suggest that government spending and deficits as a proportion of GNP have started to decrease and will continue to do so. The Gramm-Rudman-Hollings legislation, with all of its faults, nonetheless has encouraged Congress to focus on the problem and commit to longer-term spending control. This legislation signaled a recognition by the Congress that the process has begun. More important than meeting specific, precise numerical goals, there now does seem to be a continuing commitment toward slowing the growth of Federal expenditures.

This commitment is not only important in and of itself, but as a demonstration to our industrial trading partners that the U.S. will reduce our use of foreign capital for unproductive purposes. More specifically, it demonstrates that the U.S. does not intend to continue to use foreign sources of capital to finance government consumption.

Such a commitment enhances the likelihood of the adoption of more consistent macroeconomic policies among industrialized and less developed countries.

A fourth necessary ingredient for sustainable economic expansion is more balanced growth among industrialized countries. Nations experiencing high trade surpluses -- such as Germany and Japan -- are currently experiencing very sluggish domestic growth. Evidence suggests that some of these countries have underutilized labor and capital capacity which combined with substantially reduced price pressures provides the potential for more growth in domestic demand. In both Germany and Japan, wholesale prices actually fell about 10 percent in 1986 and their unemployment rates are very high historically. Economic prospects for 1987 have recently been revised downward in both countries. Accordingly, it would appear that there is room for improvement in domestic income growth so that domestic spending more closely matches their potential for non-inflationary capacity growth.

Such improved growth would not only benefit U.S. export performance but that of worldwide export markets; both global trade patterns and LDC export performance would therefore improve. Moreover, such action would contribute to exchange rate stability -- especially if Germany and Japan ultimately adopt a tax policy that improves their growth potential. Some improvement along these lines should be likely if both countries carry through on their commitments made at the recent meetings in Paris.

As suggested above, sustained balanced growth in industrial countries is a critical element in the orderly resolution of LDC debt problems since improved export markets for LDC products would improve the prospects for debt service. This brings me to the final necessary condition for a continued stable expansion; namely, sustained growth of LDC's. Such growth is critical not only to promote balanced worldwide expansion but economic growth is the only way that LDC debt problems can be genuinely resolved.

In prescribing policy conditions, it should be remembered that in order to improve their prospects for growth, LDC's must increase investment and it may be necessary to supplement domestic saving with capital from abroad. And to attract capital, a private sector environment in which property rights are well established and tax rates and regulations do not overburden investment is essential. It must be remembered that improved capital inflows to LDC's necessarily imply lower current account surpluses or even current account deficits for some of these countries. Indeed, more rapid economic growth itself may imply current account deficits for such countries -- as was the case in the U.S. for several decades of its early history. Growth objectives and various implications of pro-growth policies must be kept in mind while LDC's are working their way out of debt financing problems. Such implications may, for example, include current account deficits and even temporary periods of growing debt. After all, it is the use to which debt is put which determines whether it contributes to economic growth.

Conclusion

I have summarized monetary policy's goals for 1987, described the current economic setting, and set out some major necessary ingredients for sustained non-inflationary worldwide expansion. It is worth reiterating that the Federal Reserve's promotion of price stability is critical to the successful implementation of virtually all of the important ingredients for growth described here.

I am confident that we can bring about these necessary conditions for further economic prosperity. Indeed, we have made initial progress on all fronts. Federal Reserve monetary policy, the Gramm-Rudman-Hollings legislation, the G-6 agreement, and the Baker debt initiative, for example, all have moved us in the right direction. If we can continue to move forward in this manner we can set the stage for the longest non-inflationary expansion of the post-war era. Certainly this is an objective worthy of our best efforts.

Thank you.