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The Economic Outlook and Monetary Policy

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I'm pleased to be with you at an especially appropriate time to ponder the economic outlook and monetary policy. We--the Federal Reserve--recently announced our target and monitoring ranges for the monetary and credit aggregates for 1985. This year's ranges, and the way they are depicted graphically, have some features that bear discussion. My plan today is, first, briefly to review the general methods of monetary policy, then to discuss the current economic situation (which forms the backdrop for the Fed's monetary policy decisions), and finally to interpret the 1985 monetary target ranges.

My thesis is that the monetary policies adopted are broadly consistent with the achievement of rather moderate growth for the U.S. economy, with stable inflation and unemployment rates. However, under certain circumstances that I will describe, the narrower aggregates (M1 and M2) may move to the upper part or even above the upper boundaries of their 1985 ranges, compatible with a moderately expanding economy.

The Framework of Monetary Policy

Monetary policy is now formulated and implemented 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. Congress requires the Federal Reserve to establish and announce these objectives twice yearly. We give narrower money measures, M1 and

M2, the most weight because they are found to have the most reliable relationships with GNP and with prices. Central bank experience here and in other countries indicates the pragmatism of utilizing growth in monetary aggregates expressed in target ranges as key indicators for gauging the impact of monetary policy actions on the economy, and for communicating the thrust of policy intentions to the public.

The inherent lags in monetary policy's impact on the economy are intuitively difficult to comprehend, but it must be understood that monetary policy actions lead movements in the economy. Was the monetary policy exercised in a particular past period appropriate? The answer is complicated by a normal lag of from 3 to 6 months from policy actions to the subsequent growth of real spending. A deeper complication arises from a longer lag of 1-1/2 to 2 years (some say longer) from the same policy actions to their associated effects upon inflation. Because of these lags, and the lack of consensus as to their exact durations, it is infeasible 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.

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, as well as

indicators of international economic developments (e.g., exchange rates). Any well-reasoned discussion of the 1985 target ranges obviously must involve evaluation of current economic conditions, and a variety of "leading indicators." Let me turn, therefore, to the economic outlook.

Economic Outlook

The Fed's emphasis on monetary aggregates reflects the long-run neutrality of money: the view that over the long haul, 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, inflation has been reduced significantly, falling from 9 percent in 1981 to around 3-1/2 percent in 1984 (as measured by the GNP deflator).

Moreover, the probability of inflation reaccelerating this year, or even next year, seems smaller than has been characteristic of recent expansions, and inflationary forces and factors currently may even have some downward momentum, on balance. Looking ahead, developments in wage inflation and productivity are among the most important factors in the outlook for disinflation. For 1984 as a whole, compensation per hour rose by just under 4-1/2 percent, and non-farm productivity increased about 2-1/2 percent. These figures imply an increase in unit labor costs of somewhat less than 2 percent in 1985 (these costs were unchanged last year), compared with a very high 9 percent average increase in 1978-82. Moreover, 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 the markets for the factors of production, measured by the unemployment rates and by global--not just U.S.--capacity utilization rates, also suggests stable inflation and stable price expectations. This is particularly true in the labor market, where the civilian unemployment rate stood at a high 7-1/2 percent in January. For total U.S. industry, the utilization rate currently is somewhat 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 the surge in imports.

Commodity prices and exchange rates have also applied downward pressure to inflation in recent years, with prices of industrial materials having fallen by more than 10 percent in 1984 alone. In one important area, oil prices, the risks now appear to be mainly on the downside.

Of course, a main, worrisome factor for inflation is a possible decline in the value of the dollar, with an associated upward pressure on U.S. inflation rates. Three years of a rising dollar and massive trade deficits have reversed America's investment outflows and drawn down our overseas assets.

In the first 2 years of our recovery, the strong dollar was considered by many as merely an indication that the U.S. economy was an

"engine of expansion," a means whereby our trading partners could stimulate tardy recoveries, and a source of dollar exchange for less developed countries to meet interest payments on massive debts. But, as our trade deficits have escalated to unprecedented levels, the dialogue has turned, less positively, to the loss of American jobs in manufacturing and agriculture, some of which appears to be permanent. While some of the foreign investment of the past three years has been in U.S. firms, in joint corporate ventures, in real estate, and farmland, the trade deficit magnitudes are so large that very substantial funds have flowed into financial assets, spurred by changes in withholding tax laws and high real U.S. interest rates. Such liquid investments, I presume, are necessarily made with an awareness of the risk of a falling dollar in the future.

There are those who argue that the dollar eventually must decline if large trade deficits persist because foreigners' portfolios will become saturated with U.S. securities. This is a sensible argument; but the all important question is of timing, about which unfortunately little seems to be known. Will the dollar depreciate this year, in 2 years, or in 3? Moreover, with respect to inflation in the U.S., apparently it would take a precipitous decline in the dollar to boost prices very much. One rule of thumb is that a 10 percent dollar depreciation implies 1-1/2 percent higher consumer prices in 2 to 3 years.

There has been a great deal of discussion recently of the widely reported central bank interventions in foreign exchange markets.

My remarks are focused on the fundamental factors affecting exchange rates, since I am discussing monetary policy for 1985 as a whole, and beyond. With that in mind, I would just say that although there is evidence that intervention has very limited power to overcome fundamental factors affecting exchange rates, it can from time to time be beneficial in stemming disorderly exchange rate movements.

Finally, inflation expectations appear to have moderated significantly in the 1980s. Most surveys show gradual declines in price expectations from a peak in 1980. The January 1984 Decision Makers Poll by Richard Hoey and Helen Hotchkiss, for example, shows 10-year inflation expectations dropping to 5-1/4 percent compared with a peak of almost 9 percent in late 1980.

Turning to the outlook for the real economy, in my opinion the most likely outcome is that real GNP will show a healthy but moderate increase in 1985, hopefully enough to produce small decreases in the unemployment rate later in the year. The probability of a growth recession has diminished following the revised estimate of nearly 5 percent real GNP growth in the fourth quarter of last year, following sluggish 1-1/2 percent growth in the third quarter. This pickup in GNP, in combination with sizeable declines in long-term interest rates (despite very recent increases, the 10-year Treasury rate is still about 175 basis points below June), suggests room for optimism. Another sign of expansion, suggesting strength in the future, is the rapid growth of the monetary aggregates, especially M1, after the flat period of July through October.

Of course, the short-run outlook for real GNP is not totally unclouded. On the negative side are movements in a number of real economic factors considered to be precursors of economic activity. These factors can be illustrated by the composite index of leading indicators, which despite a surge of 1.7 percent in January, remains below its level in May of last year.

This and other vulnerabilities remain in the third year of expansion. U.S. capital spending increasingly flows to foreign sources, even in the high technology market. New orders for nondefense capital goods fell sharply in January, following declines on balance in the third and fourth quarters of last year. We are buying foreign-made goods as never before, and the strong dollar makes inexpensive labor in Pacific Rim and developing countries look even less expensive.

The 1985 Target Ranges

The outlook I have just described--essentially a healthy one of moderate growth and the possibility of further disinflation--conditioned the determination of the monetary targets, which, in the past weeks, have had widespread attention and review. There was a slight liberalization of the upper bounds for M3 and for the monitoring range for domestic credit; and there was a one percent reduction from 1984 in the upper boundary for the narrow aggregate, while M2's range was unchanged from last year. Congressional testimony by Chairman Volcker included the caveat that one or more of the aggregates might grow around or even above the upper boundaries of their ranges during the year. In his charts, he showed the ranges as moving within parallel bands, in addition to the cones or wedges displayed in the past.

In interpreting these ranges, it is important to put more emphasis on M1 and M2, since these aggregates have the more reliable relationships with GNP. Focusing on the two narrower aggregates, the reduction in the M1 range is consistent with the Fed's policy of disinflation, of gradual reductions in monetary growth over time. However, the range for M2 was held the same as last year. And, 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. Moreover, the approach of using parallel bands rather than cones is a graphic reminder that the growth rates of M1 and M2 both have exceeded their upper boundary growth rates so far this year.

These characteristics of the 1985 ranges naturally raise a question about the thrust of policy. Now that inflation seems to be well in hand, is the Fed implicitly or subtly deemphasizing its objective of further reductions in the inflation rate? Not at all. Economic growth at or somewhat above the FOMC range of 3-1/2 to 4 percent need not be reflationary. On the other hand, "easy money" under today's circumstances is not called for. My main point this afternoon is that there are solid technical reasons for these changes in monetary ranges, and for a flexible implementation of policy, which do not indicate complacency about inflation.

First, the use of parallel bands rather than cones simply reflects reality. Geometry cannot be permitted to drive policy. It simply is not reasonable to think that the Fed should sacrifice economic growth to keep money in a pictorially arbitrary and narrow range

in the first quarter of each year. This point seems to be recognized and accepted by the marketplace. In addition, the issue of "bands" versus "cones" has little to do with longer-run policy, since both methods describe the same money growth range for the year as a whole.

It is worth mentioning that the Fed did not take the advice of the Council of Economic Advisers and base the 1985 ranges on the end points of last year's ranges. Instead, the Fed maintained its approach of starting this year's ranges from the values actually recorded for the monetary aggregates in the fourth quarter of last year. Evaluated as a long-run procedural issue, the so-called rebasing proposal represents an overly rigid approach to monetary targeting, giving the Fed too little flexibility to react to the situation that actually exists when new ranges are chosen.

The need for flexibility may come into play this year. There may be a need for somewhat faster growth in M1 and M2 this year compared to last year because 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 may be necessary to achieve a given path of aggregate demand; it does not mean taking one's eye off the danger of reinflation.

Velocity: Money's Turnover

The growth in the income velocity of a monetary aggregate can be broken down into trend and cyclical components. Over 1960-80, the income velocity of M1 (known as V1) had a trend rate of growth of 3 percent, while the velocity of M2 (known as V2) had a flat or zero

trend. However, part of the V1 trend was a function of secular increases in interest rates, which in turn were influenced by rising inflation. Today's disinflation gives little reason to extrapolate the full 3 percent historical V1 trend. The empirical evidence suggests that a velocity trend of between zero and 2 percent is most likely for M1, and a trend of between minus 1/2 and positive 1/2 percent is likely for M2. If real GNP growth ranges above the widely forecasted band of 3 to 4 percent, velocity could be slightly higher.

With the trend growth of velocity in a low range, the cyclical component of velocity would need to be positive to produce growth rates like those observed in the 1960s and 1970s. The major factor behind cyclical movements in velocity is interest rates; velocity is increased by rising interest rates and decreased by falling interest rates. Even flat interest rates could produce sluggish velocity growth. Any appreciable decline in interest rates easily could convert this trend into declining velocity.

As far as 1985 is concerned, no interest rate declines from present levels would be necessary to accompany weak velocity. The lagged effects of the rather substantial interest rate declines beginning in August of last year should apply downward pressure to velocity in the first half of this year. The federal funds rate, for example, fell from over 11-1/2 percent in August to around 8-1/2 to 8-3/4 percent recently. Of course, the effect of this on velocity growth for the year as a whole could be offset if there were increases in interest rates later this year. Still, these increases would have to be

reasonably large to produce rapid velocity growth on balance in 1985. My point is not to forecast interest rates, but to emphasize the uncertainties and complications in the velocity picture that played a part in our policymaking in February.

The continuing megadeficits in our balance of trade and in our federal budget add to these complications. Even if these two massive deficits are not reduced substantially this year, a continued inflow of foreign saving could be forthcoming for the same multiplicity of reasons as in 1984--yield, safety, liquidity, and marketability, thus maintaining a downward pressure on financial markets. Again, too many uncertainties attach to the strength of the dollar to forecast interest rates, and in turn to anticipate the impact of changing rates upon M1 velocity. But, it appears that velocity may be negative for the first months of 1985.

Policy Implication

A prolonged decline in velocity would require a comparable period of rapid M1 growth to avoid an overly contractionary monetary policy. Thus M1 and M2 easily could have to grow in the upper part of their ranges, or even exceed them in 1985. To illustrate this point consider one of many possible outcomes--a 7 percent 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 could push M1 and M2 growth to around their respective 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. In effect, the more rapid money growth would be necessary to counteract the contractionary effects on real GNP of weak velocity. In such circumstances, more rapid M1 growth would not imply that the Federal Reserve was abandoning its primary goal of further, gradual disinflation.

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 largely a response to the decline in inflation and interest rates in 1982--the Fed permitted rapid M1 growth; M1 grew at an 8-3/4 percent rate in 1982 and a 12-1/2 percent rate in the first half of 1983. 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 1982-84.

Conclusion

We have what I consider a splendid opportunity to continue along a path of economic growth, which can provide the resources for

much-needed reinvestment, "reindustrialization," and renovation of our urban infrastructure. Moreover, attainment of these objectives to a major degree would, in turn, contribute to the restoration of our national competitiveness in world markets and to the restoration of a balanced trade picture.

The target ranges of the monetary aggregates are broadly consistent with this picture and with moderate economic growth, but it may be necessary for the narrower aggregates, M1 and M2, to increase around, or even above, the upper limits of their ranges, if velocity is sluggish. The economic opportunity is considerable enough to warrant consideration of the adjustments to policy necessary to attain that end.