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The Economic Outlook and Monetary Policy in the United States

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It has been a little over a decade since the world moved to a system of floating exchange rates. One of the anticipated benefits of the new system was that each country could conduct its economic policies without so much concern about the other countries' policies. But as we all know, in the real world such anticipations are seldom realized in full. Economic relations between Japan and the United States are a prime example of current attention by the leadership of two countries focused on the interactions between their economies. The factors involved are well known to all of you--government budget deficits, trade policies, the relative strength of economic recoveries, comparative inflation rates, exchange rates, and a host of other considerations.

Let me quickly dispel any impression that I am here addressing these complex interactions between the interdependent economies of Japan and the United States. I allude to these difficult questions only as background to a less ambitious goal. United States monetary policy is the one piece of the economic complex for which the Federal Reserve System has responsibility. Thus, my main purpose this morning is to provide insight into U.S. monetary policy goals for 1985 and beyond, and to relate them to the outlook for the U.S. economy. I aspire to make a contribution to your understanding of developments in the economy of your major trading partner as they unfold, and to your assessments of developments in economic relations between our two nations.

The Federal Reserve's Approach

It is understandable that the approach to the conduct of monetary policy in the two countries differs somewhat. The Federal Reserve focuses more on monetary aggregates, whereas I understand that the Bank of Japan gives more weight to interest rates. The Bank of Japan does, of course, make short-run forecasts of monetary aggregates. The Federal Reserve formulates and implements monetary policy primarily in terms of annual target ranges for growth in three monetary aggregates, and with an eye on growth in total domestic nonfinancial debt. We give narrower money measures, called M1 and M2, the most weight because they are found to have the most reliable relationships with changes in the gross national product and in prices. M1 is basically a transactions aggregate, composed of currency in circulation and checkable deposits. M2 includes M1 plus funds held in a wide variety of liquid savings-type deposit and nondeposit instruments.

The inherent lags in monetary policy's impact on the U.S. economy are important reasons for our focus on monetary aggregates. The conduct of policy in the United States is complicated by a normal lag of from 3 to 6 months from policy actions to the subsequent growth in output, and of somewhere around 1-1/2 years to their associated effects on inflation. Because of these lags, it is not feasible to conduct effective policy by looking only at current economic developments, especially since economic data are revised frequently. Such a policy would be "fine tuning," overly reactive, and it could be destabilizing if pursued on a quarter-to-quarter basis. So the decisions made by the Federal Reserve so far this year are relevant to growth in real GNP

later in the year, but are not likely to affect inflation until after mid-1986.

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 we look at the myriad of monthly and quarterly statistics on the progress of the economy, including indicators of international economic developments, which have taken on such increasing significance in recent years. Any well-reasoned discussion of plans for policy in 1985 obviously must involve evaluation of current economic conditions, and a variety of "leading indicators." Let me turn, therefore, to the economic outlook.

The United States Economy

You are aware that the Federal Reserve placed increased emphasis on monetary aggregates at the end of 1979. That change in policy procedures reflected the recognition that inflation is a monetary phenomenon over longer time spans, and that a central bank can best contribute to disinflation by reducing money growth rates gradually over a period of years. Since 1979, U.S. inflation has been reduced significantly from 9 percent in 1981 to around 3-1/2 percent in 1984 (as measured by the GNP deflator). In the first quarter of this year, the GNP deflator appears to have jumped to a 5-1/2 percent rate of increase. However, this reflected distortions, in part, due to large shifts in the composition of imports, including those from Japan. Other measures that are not distorted in this way show a continuation of the moderate inflation trends of last year.

The Federal Reserve's contribution to disinflation appears to have increased its credibility in the marketplace. Along with the decline in recorded inflation, there also appears to have been a drop in inflation expected for the future. A March 1985 survey of financial decision makers conducted by Hoey and Hotchkiss, for example, shows 10-year inflation expectations having dropped to 5-1/2 percent compared with a peak of almost 9 percent in 1980.

With the one exception I will mention shortly, the probability of U.S. inflation reaccelerating this year, or even next year, seems relatively small. For 1984 as a whole, favorable developments in wages and productivity produced an increase in the cost of an average unit of labor of about 2 percent in 1984, compared with a very high 9 percent average increase in 1978-82. Despite an apparently temporary jump last quarter, these trends seem likely to continue. Wages in major U.S. union contracts agreed to last year and early this year were quite modest. There is a respectable band of American economists who think that productivity is on a new higher trend line, up from its sluggish performance in the 1970s. Although data on productivity over the past year or so cast doubt on the view that the new trend is dramatically higher, the new more competitive structure of the American economy still appears to have an improved potential for productivity.

The degree of slack in the U.S. labor market, with its high 7-1/2 percent civilian unemployment rate in March, also is favorable for further disinflation. Supporting this factor, the utilization rate for U.S. industry currently is below its average or "full" utilization value of the previous 15 years. Moreover, excess capacity in U.S.

trading partners also keeps downward pressure on U.S. prices, since this capacity may be "passed through" to U.S. consumers through imports.

The possibility of a sustained decline in the value of the dollar must be considered a risk in the prospect for further disinflation in the years immediately ahead. A decline in the trade-weighted value of the dollar erodes the profit margins of foreign vendors and perhaps those of their distributors in the United States. The extent to which this process produces inflation depends, in part, on whether sellers are more concerned with regaining their margins or with maintaining their shares of the United States market. These kinds of "slippages" make it difficult to estimate the impact of exchange rate movements on prices. But, on the basis of past experience, a 10 percent depreciation of the trade-weighted value of the dollar is estimated to add about 1-1/2 percent to the level of U.S. consumer prices within 2 to 3 years.

The rising dollar thus far in the 1980s, of course, has put downward pressure on U.S. prices. However, the majority of analysts argue that the dollar eventually must decline of its own weight and by a significant amount, because the strong dollar has contributed to large current account deficits. They argue that if these current account deficits persist, foreign portfolios eventually will become saturated with dollar-denominated securities, and that as a consequence the demand for dollars will fall. This is a sensible argument; but the all important question is of timing, about which unfortunately little

seems to be known. Will the saturation level be reached this year, in two years, or when?

The dollar, in fact, has declined on balance since the end of February. It seems unlikely to me, by the way, that this was primarily a consequence of central bank intervention in the foreign exchange markets. Studies stemming from the Williamsburg economic summit suggest that such intervention has limited power to overcome fundamental factors affecting exchange rates, although intervention can from time to time be beneficial in stemming disorderly exchange rate movements, or in reinforcing market strength or weakness, if used selectively.

It is possible that intervention earlier this year may have helped brake possible speculative pressures pushing the dollar up, by introducing some uncertainty into short-run exchange rate movements. But fundamental factors seem to have made more important contributions to the dollar's recent decline. One was the growing perception in the markets that U.S. economic growth had weakened somewhat, and thus that the chances of the Fed tightening monetary policy had diminished. In addition, the closing of a number of small depository (thrift) institutions in the state of Ohio raised the prospect in the minds of some market participants that the stability of the U.S. financial system might not be as absolutely secure as previously thought. Once it was clear that this situation was delimited, this influence on exchange rates seemed to wane. Nevertheless, this experience serves to warn us of the importance of the safe-haven motive for holding dollars, and highlights the difficulty in anticipating exchange rate movements.

Turning to the outlook for the real economy, there seems to be a reasonable chance that the U.S. real gross national product will show a healthy but moderate increase for 1985 as a whole, hopefully enough to avoid a growth recession--defined as slowly rising GNP and a rising unemployment rate later this year. In broad terms, the desirable outcome seems to be supported by reductions in real interest rates since mid-1984, and recent rapid growth in the monetary aggregates. As April ended, the inflation-adjusted rate available on 10-year U.S. Treasury notes was over 150 basis points below its May 1984 peak. Although M1 decelerated in March, it has grown at a rapid 10 percent rate since last October 1984.

However, a U.S. growth recession must be considered a real threat. In fact, the data currently available suggest that the American economy is on the edge between healthy, sustainable growth and a growth recession. If the most recent estimate of 1-1/4 percent first-quarter real GNP growth is roughly correct, the U.S. economy has advanced at only about a 2-1/2 percent rate over the past three quarters. I am not aware of solid analysis suggesting that continued growth at this pace would produce any perceptible reduction in unemployment rates.

The so-called index of leading economic indicators in the United States also presents a mixed picture of the future. This index, which contains 12 data series that normally lead the business cycle, declined slightly in March, and it still is below its peak of last May. The sharp increase in housing starts in March might be considered

encouraging, except that nearly all of the increase came in multi-family units, where a great deal of overbuilding appears to have occurred already.

In the first two years of the recovery, the strong dollar and the associated trade deficits were considered by many to be an "engine of worldwide expansion," whereby our trading partners could stimulate tardy recoveries, and a source of foreign exchange proceeds for less developed countries. The trade deficits also were viewed as having certain beneficial effects domestically for the U.S. economy, at least given the existence of large deficits in the national government budget. Trade deficits have made foreign savings available help offset the drain on savings represented by the budget deficits. As a consequence, real interest rates in the United States probably have been lower than would otherwise have been the case, thus reducing the extent to which spending on housing and business-fixed investment has been crowded out by the budget deficits.

But as our trade deficits have escalated to unprecedented levels, the dialogue has turned to the loss of American production and jobs in sectors that rely significantly on exporting their products. This concern is especially great because basic structural changes appear to be occurring in certain U.S. industries, and thus some of the loss of jobs appears to be permanent. Moreover, to the extent that sectoral imbalances adversely affect the prospects for growth in the U.S. economy, it will be especially burdensome for future "debtor-nation" generations to pay off the large debts, a good deal of which are owed to foreigners.

Part of the debate about the U.S. trade deficit has focused on the bilateral deficit with Japan, which reached a high \$34 billion level last year. Of course, there are those in the United States who argue that this situation has to do with more than just the large United States budget deficits and high real interest rates: they point also to Japanese trade practices. As I mentioned earlier, my purpose today is not to pass judgment on the relative weights to be attached to various arguments in this debate. However, I cannot avoid saying that the specter of increasing protectionism may well represent the single biggest threat to the economic recovery, world wide, that currently exists. As I will discuss in a minute, this and other problems associated with the current trade imbalances raise the question of how much emphasis these factors should be given by the Federal Reserve in formulating monetary policy.

Monetary Policy

The outlook I have just described--essentially risky for economic growth, with a chance of further disinflation--conditions an interpretation of the target ranges for the monetary aggregates and of monetary growth in 1985. The 4-7 percent range for M1 involved a one percent reduction from 1984 in the upper boundary, while M2's 6-9 percent range was unchanged from last year; and there were slight increases in the ranges for M3 and domestic credit. In addition, we specified the caveat that one or more of the aggregates might grow in the upper parts of their ranges during the year.

The reduction in the M1 range is consistent with the Fed's policy of disinflation, of gradual reductions in monetary growth over the long run. However, even in the case of M1, growth in the upper part of the range would exceed the 5-1/4 percent growth rate observed last year. Moreover, M1 grew at a 10-1/2 percent rate in the first quarter of this year compared with its 7 percent upper boundary, and M2 grew at a 12 percent rate compared with its 9 percent upper boundary.

These observations naturally raise a question about the thrust of policy: now that U.S. inflation seems to be better under control, is the Federal Reserve implicitly or subtly deemphasizing its objective of further reductions in the inflation rate? And, in addition, has the Federal Reserve shifted its emphasis toward attempting to correct some of the imbalances that currently beset the United States economy? For example, some of our critics argue that the strong dollar and the associated trade deficit primarily are the result of overly restrictive monetary policies that have kept real interest rates too high. In this view, it might be possible for the Federal Reserve to gradually ease the upward pressure on the dollar and thereby contribute to a reduction in the trade deficit by pursuing more expansionary policies that would reduce real interest rates. This, it is argued, could help sectors of the U.S. economy that compete with imports, and could help take some of the "steam" out of the protectionist threat, which most recently has arisen in the United States in response to the bilateral trade deficit with Japan.

One of my main purposes today is to make it clear that the Federal Reserve is not giving up on efforts to achieve further disinflation. Although it certainly is desirable to avoid exacerbating problems of external imbalance, it would be a major mistake for the Federal Reserve to shift its emphasis toward pursuing international objectives at the expense of the domestic economy. Such an approach most likely would end up damaging not only the United States economy, but also the economies of our trading partners.

The large deficit in our national government budget is a major factor behind the high real interest rates in the United States. This is a reason why we have been able to enjoy an economic recovery for the past two-plus years, while at the same time real interest rates have been at historically high levels. In view of the strong demands coming from the government sector, an attempt by the Federal Reserve to bring the exchange rate down by artificially lowering real interest rates most likely would mean an overly expansionary monetary policy that ultimately would contribute to the re-inflation of the U.S. economy. The experience in the late 1970s and early 1980s dramatically demonstrated the destabilizing effects of high and volatile U.S. inflation on the domestic and world economies.

Thus the flexible implementation of monetary policy so far this year, with M1 and M2 both growing above their target ranges, cannot in my view be justified by considerations of external imbalance. Instead, this flexible approach is needed because, as I mentioned earlier, the economy has been sluggish for the last nine months, and

there is a reasonable risk that it could inadvertently slip into a growth recession. A temporary episode of M1 growth in the upper part or even somewhat above its range can reduce the risks of this occurring, without reigniting inflation, as long as this approach is not pursued too long.

On technical grounds, this approach is justified by the possibility that growth in the velocity, or rate of turnover, of money may be weak this year. The velocity of M1 fell at a rate of almost 4 percent last quarter, mainly because of a lagged response to the interest rate decline in the latter half of last year. If velocity growth reverts to its apparent trend rate of around 1 percent, velocity would be roughly unchanged for the year as a whole. Thus, fairly rapid money growth may be needed for a time to counteract the contractionary effects on GNP of weak velocity.

Far from putting domestic goals aside in favor of external ones, the current developments in monetary policy seem to me to be consistent with continuing promotion of a soft landing for the U.S. economy—a result in which the economy grows at a sustainable pace consistent with further gradual reductions in inflation and unemployment. These arguments for concentrating mainly on domestic developments do not deny the importance of correcting external imbalances. However, correction of this latter problem should come mainly from other sources, since concerted Federal Reserve attempts in this area could lead to even bigger problems.

There are reasons for optimism that the trade balance will be improved--there are signs of somewhat faster expansion in the economies of our trading partners, of progress being reached in the area of trade policies, and of the U.S. Congress moving closer to curbing the U.S. budget deficit. The interdependence of the global economy demands the supreme effort in these endeavors. In the meantime, my view is that the Federal Reserve has only one reasonable option: to exercise the flexibility in the conduct of domestic monetary policies necessary to promote healthy economic growth and further disinflation in the U.S. economy.