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THE U.S. ECONOMY OVER THE NEXT FIVE YEARS

Summary of remarks by

Henry C. Wallich
Member, Board of Governors of the Federal Reserve System

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American Economic Association

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1. The medium-term outlook today seems to present a wider range of alternatives than usual. In years gone by, it would have been a safe bet, at almost any time, to say that the next five years would bring growth at an average historical rate, whatever the short-run prospects might be. We have put in place powerful factors that should stimulate and sustain prolonged growth:

- a. Inflation has been brought down sharply.
- b. Tax incentives for business investment have been put in place.
- c. Saving is being encouraged by more favorable tax treatment and positive real interest rates.

2. Building on these elements of strength, we should be able to look forward to:

- a. A rate of growth somewhat above our long-run potential.
- b. A decline in unemployment closer to its noninflationary minimum.

- c. A continued decline in inflation to not far from zero.
- d. A corresponding decline in interest rates.

3. This is the optimistic scenario. But there is another set of possibilities:

- a. Abandonment of anti-inflationary policy leads to a quick burst in economic activity.
- b. Inflation reaccelerates while interest rates are held down.
- c. We continue the sequence of cycles of ever higher inflation, eventually higher interest rates, and then renewed recession with still higher unemployment.

4. I do not regard this scenario as likely because it requires a combination of mistakes in policy to materialize. But in order to achieve the optimistic scenario, a number of problems need to be dealt with.

- a. Ways must be found to deal with the enormous structural budget deficit of perhaps \$100 billion that now seems to stretch into the indefinite future.
- b. High unemployment must be dealt with not only through cyclical recovery, but by more targeted means.
- c. High real interest rates, largely a product of the budget deficit, need to come down.
- d. Protectionist pressures need to be resisted.
- e. The enormous current-account deficit in the balance of payments now in prospect must be reduced and, in the short run, financed without damage to the dollar.
- f. Inflation must be reduced as close to zero as possible.

5. Most of these problems are self-inflicted. Their cure is at least in part in our hands. There are other possible difficulties outside our control which, however, would become more manageable if we put our own house in order.

- a. The pervasive economic weakness abroad, in industrial as well as in developing countries, with possible repercussions on the world financial system.
- b. Mounting protectionism abroad.
- c. The ever-present possibility of adverse political events abroad and the consequent risk of a new oil shock.

6. If inflation continues to diminish, Federal Reserve policies will continue to play a role in the economy, but a less conspicuous and controversial one. Two main questions will need to be answered.

- a. Will it be possible to continue an effective anti-inflationary policy?
- b. What are the techniques by which Federal Reserve policy should be implemented?

7. As to the orientation of policy,

- a. A continued effort to bring inflation down appears essential, even though the objective of perfect price-level stability may not be reachable.
- b. Calling off the effort on the grounds that enough has been achieved is likely, later if not immediately, to lead to a new resurgence of inflation.
- c. Even at 6 percent inflation, the tax system still generates serious distortions and makes real rates for many lenders and borrowers negative.

- d. Falling unemployment and stable growth are not inconsistent with continued disinflation. On the contrary, they could not be long maintained, even if temporarily achieved, at high rates of inflation.

8. The effort to bring down inflation has been costlier than it would have been had not almost exclusive reliance been placed on monetary policy. To reduce dependence on monetary policy for this purpose, we should

- a. Move to a less stimulative fiscal policy that would add to downward pressures on real interest rates.
- b. Restrain government price-raising actions, in the form of protectionism, regulation, price supports, inadequate antitrust action, minimum and mandated wage increases.
- c. As a mild form of incomes policy, we might explore profit sharing and year-end bonuses as means of making moderate wage increases acceptable.

9. If it turns out that we cannot make further progress against inflation, we should make adjustments in our tax structure and debt management practices so as at least to soften the damaging effects of inflation, by

- a. Eliminating the taxability of the inflation premium in the interest rate to lenders and its deductibility to borrowers.
- b. Enabling savers who wish to protect their saving with an opportunity to buy an indexed security.

An ending of inflation clearly would be much preferable to measures like these.

10. As regards Federal Reserve techniques in the medium-term, the following conclusions stand out:

- a. Targeting on the monetary aggregates has been an effective and persuasive way of dealing with inflation because the inflationary implications of excessive money growth are widely understood.
- b. Of the monetary aggregates, M1 at present is in disarray owing to interest-rate deregulation. Its eventual rehabilitation as a monetary target is uncertain. M2 and M3 are not impacted to the same extent.
- c. Targeting on the broader monetary aggregates, or on a credit aggregate, or perhaps even on the monetary base seems entirely possible, although each presents problems.
- d. Targeting on nominal GNP is technically difficult and not an appropriate function for a central bank.
- e. Targeting on interest rates has been tried repeatedly in our history and has proved to have an inflationary bias.
- f. Targeting specifically on low interest rates can lead to explosive inflation.
- g. The ability of monetary policy to control nominal interest rates is very short-lived in our highly sensitized environment and threatens quickly to become counterproductive.
- h. The control of real interest rates, even if they could be discerned, is outside the powers of a central bank except in the very shortest run.
- i. Only fiscal policy, by altering the budget deficit and the government's absorption of saving, can influence real interest rates.