SUSTAINING ECONOMIC RECOVERY:
REMOVING THE OBSTACLES

Remarks by
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Your kind invitation to meet with the Central Missouri CPCU Society today was particularly welcome. I do appreciate this invitation because occasions such as these are excellent opportunities to discuss key issues of concern to the Federal Reserve in the period ahead with groups such as this. Of course, the fundamental issues which concern the Federal Reserve are most likely the same basic issues which concern thoughtful people in the insurance industry-- issues like inflation, recession, and economic recovery.

Given the extensive shifting of economic sands which has occurred in the nation over the past year or so, and given the opinions of many observers that economic recovery has begun, it will perhaps be useful today to try to sort out the meaning of the economic happenings we have witnessed in recent months.

Against the backdrop of historically high inflation and a stubborn recession, we have seen quite a varied menu of economic developments over the past year. One the one hand there have been continuing declines in production and high levels of unemployment, which contributed to a 2 per cent decline in GNP for 1982. On the other hand, we've seen vigorous upsurges in stock and bond markets, and a major lessening of inflationary pressures.

Good News – Bad News – moses –

To be sure, the economic headlines in 1982 made disappointing reading, tracing as they did the economy's dismal performance. As you know, high interest rates brought on by years of inflation affected many key sectors of the economy. The bellwether housing and automobile industries declined further, and business capital spending was extremely weak as the second recession in three years rippled through the economy.

The human dimensions of the business downturn were reflected in the rise in unemployment throughout the year. Even states like Missouri, with traditions of stable diverse economies, were not spared. We were paying a high ~~cost~~ price to wring inflation from the economy.

Yet, in the face of such a deep recession, some long-awaited indications of economic recovery have recently ~~become apparent~~ begin to appear. Among these welcome signs are the so-called leading economic indicators--including the stock market--which have been positive nearly every month since mid-1982. Underlying trends suggested by these indicators were confirmed when declining inflation, together with weakness in business activity, prompted a general decline in interest rates during the second half of 1982. Declining interest rates, in turn, have encouraged a rebound in housing and auto sales, two of the most interest-sensitive parts of the economy. January housing starts were up 36 per cent and auto sales have remained fairly strong. Furthermore, industrial production grew strongly last month, retail sales were positive, and the unemployment rate declined.

Although these favorable economic developments certainly brighten the prospects for business recovery, many people are understandably rather gun-shy now. Many question the economy's ability to sustain the recovery through 1983 and into future years. Given the critical importance of sustained economic growth to the nation, I want to discuss this question with you briefly today from two perspectives. First, I want to consider the near-term outlook, — 1983 and into 1984 —

and second, I want to examine prospects for sustaining U.S. economic health over the longer term. —Through the 1980's—

In assessing the economy's staying power in 1983, I believe one of the most encouraging trends is the substantial progress that has been made in restraining inflation. As you know, the 3.9 per cent rise in the Consumer Price index CPI in 1982 was the smallest annual increase in a decade. In January, the producer price index actually declined, and in real terms, the price of oil--a most important economic ingredient--has been declining.

These welcome trends on the price front also are having a favorable effect on cost structures throughout the economy. We have seen lately that a significant byproduct of slower inflation is a slower rise in labor costs and an increase in labor productivity.

These price and productivity trends, Are in my judgement, ~~are~~ helping To establish a healthy ~~base~~ Foundation for the 1983 economy. So, too, is the generally lower level of interest rates. Reflecting these lower rates, interest-sensitive industries like homebuilding and automobiles and other durable goods are likely to show additional gains this year. With increasing sales, businesses are likely to rebuild inventories, spurring production levels and employment. Additional stimulus also will flow from Federal government spending, particularly for defense goods.

While these factors certainly will work in favor of sustaining the economic recovery in 1983, there are indeed, some question marks. Some observers suggest that continued high unemployment and weak personal income prospects cloud the outlook for sustained recovery. I agree that consumer spending may not be overly strong under these circumstances. Another concern is that business capital investment may continue to be weak and provide little economic stimulus in 1983.

Another problem area for 1983 is U.S. exports situation. The worldwide recession and a strong dollar resulted in a major deterioration in the nation's net exports during 1982. Given the current weakness in foreign economies, and the still high value of the dollar, export demand is not likely to turn around quickly.

Many of you undoubtedly have been concerned about the health of the international financial system. Widespread public attention has been focused in recent months on the deteriorating financial positions of many international borrowers--particularly The developing countries. Slowing worldwide economic growth left many of these borrowers exposed and raised questions about their ability to repay Their debt. Despite the high visibility of this problem, ~~I believe that~~ In my view, The official efforts now under way are serving to ease this problem considerably.

Through responsible cooperation with the International Monetary Fund, a number of countries are taking the necessary steps to put their affairs in order. As a result, major international lenders are developing confidence that orderly economic adjustments will occur.

Moreover, lower worldwide interest rates and improving economic conditions should ease pressures on both lenders and borrowers. In my judgement, the programs now on stream are likely to bring the needed confidence to international financial affairs and diminish the effects of international financial problems on our ~~the~~ domestic economy in 1983.

A key ingredient in the 1983 outlook and for the sustainability of economic recovery through the year is Federal Reserve monetary policy. It is a reasonable to ask— What are the Federal Reserve's intentions in 1983? Should the public be concerned that--as one former Fed chairman put it--the Federal Reserve will take away the punch bowl just as the party really gets going?

As background for understanding the Federal Reserve's policy intentions, you should know that the Federal Open Market Committee looks for about 4 per cent real economic growth this year. Moreover, we believe, as a group, that the 1983 inflation rate will be below the 5.6 per cent rate in the GNP deflator anticipated by the Administration.

The Federal Reserve's intentions for 1983 were set forth in mid-February when Paul Volcker met with the Congress to discuss the FOMC's agreed-upon targets for money and credit growth. He reaffirmed the Federal Reserve's objectives to maintain progress toward price stability while providing the money and liquidity necessary to support continued economic growth.

To achieve the objective of moderate noninflationary expansion in 1983, it is clear that the Federal Reserve cannot be bound by rigid rules of monetary growth, but rather must pursue these goals with a flexible policy. Such a policy will permit us to look beyond the varied impact of financial deregulation on money growth, for example, and to deal more realistically with unusual or unanticipated financial developments. The 1983 monetary targets ranges established in connection with such a flexible policy are in some cases wider and higher than ~~in~~ The 1982 targets, particularly for the widely followed and distortion-prone aggregate, M-1.

In my view, the Federal Reserve's intended approach to monetary policy in 1983 will help to insure that an appropriate level of money and credit will be available to support moderate noninflationary expansion in business activity.

On balance, then, after weighing the most significant economic variables, I believe that the economy's forward momentum can and will be sustained through 1983.

Against the background of these optimistic assumptions for 1983, I want to turn now to consider the economic outlook over the longer-term perspective. What can be done to insure that the current favorable developments in the economy can be translated into sustainable economic performance over the longer run?

IN my View ~~I believe~~ the answer to that question might read like this: The chances for a sustained expansion are certainly good if we remember the painful lessons of inflation and also address the major obstacle to long-term economic progress, AND THAT ~~which~~ is the massive deficit position for years to come in the Federal government's budget.

I am convinced that we have the opportunity ~~now~~ to make the current turnaround a long-lasting period of expansion because the

PAINFUL ~~harsh~~ lessons of inflation have become readily apparent to the American public. We ~~all~~ Now understand ~~now~~ that the inflationary excesses of the past two decades distorted our economic decisions and led to recurring recessions. Even worse, lost jobs and lost production undermined faith in our system and weakened confidence in the future. Some repairs to The public's confidence have been made recently, but there is still much more to do.

Thus, as we consider the sustainability of long-term expansion, we can draw strength from recent evidence of the fundamental lessening of inflationary pressures. This development is extremely important because diminshed inflation is a necessary precondition for permanent recovery. Precisely because the nation has come so far in the battle with inflation, that resolving the problem of the large and growing federal budget deficits has become Absolutely critical. In my judgement, this is the most serious obstacle to our nation's long-term economic health.

The dimensions of the prospective deficits for 1983 and beyond are staggering and may not be fully understood by the American public. As you may know, the Office of Management and Budget now is forecasting a $208 billion deficit this fiscal year. Even greater deficits may occur in future years unless significant adjustments are made. A major portion of the deficit this year will be related to recession-caused shortfalls in revenue / or increases in spending. But a significant part of the deficit this year will be structural in nature; By that I mean – A PART of The deficit ~~it~~ would exist even if the economy were operating at full employment. What disturbs me most is that the structural deficit is expected to grow in future years, given existing spending and revenue laws now on the books. This will happen even if the economy recovers and the recession-related part of the deficit narrows. or disappears

Not only are the prospective deficits large by absolute standards, they are growing larger relative to GNP. To illustrate, back in the Eisenhower years, the deficits--when they occurred--averaged about 1/3 of one per cent of GNP. Twenty years later, during the Carter administration, the deficit averaged about 2 per cent of GNP. Current administration projections show the deficits at 6-7 per cent of GNP, or slightly less with a strong economic recovery.

But it is not simply the scale of the prospective deficits which is the issue, but rather the potentially negative ~~impacts~~ effects on business growth, the financial markets, and the public psychology.

Because budget deficits must be financed by borrowing in credit markets, massive ongoing deficits pose a serious threat to prospects for sustained economic expansion. As business expands, private sector credit demands from businesses, farmers, and home buyers may well collide with the government's financing needs, raising again the specter of "crowding out." issues Moreover, as both public and private credit demand grows, the likelihood of rising interest rates increases, as well. Although credit demands appear manageable this year, rising interest rates later on might discourage the Private Sector borrowing needed to finance a continuing recovery. Another very important negative factor related to financing the deficit is that potential "crowding out" problems and rising interest rates--if they occur--would raise public fears about renewed inflation. Such rising inflationary expectations would surely weaken the foundation for recovery which has been laid.

As we all know, fundamental solutions to the deficit dilemma are developing very slowly in Washington because of sincere differences about the nation's Proper priorities. Until those differences are resolved, the deficit issue will remain front page news. ~~Too~~ Also, ~~so~~ As long as the stalemate persists, we probably will hear ideas which Tend To act ~~to~~ As A smokescreen and Thereby delay the decisions which must be made.

For example, some observers have suggested that the Federal Reserve could solve the deficit financing problem--and help the economy sidestep possible "crowding out" issue--by simply creating more money. This solution, which is tantamount to monetizing the government debt, will only add to The public concern about future inflation and rising interest rates. It is quite clear to me that excessive expansion of money is not the answer to massive federal deficits--or to any economic problem, for that matter. While excessive money growth may bring temporary short term benefits, such as lower interest rates, such action will ~~almost always~~ only contribute to higher inflationary pressures and higher interest rates over the long run.

We in the Federal Reserve believe that the economy has come ~~so~~ too far in the fight against inflation, and has paid ~~such a~~ too high a price to reach this point, that it would be irresponsible for the Federal Reserve to foresake such important gains in order to to validate federal budget deficits.

This view does not signify Federal Reserve insensitivity to the broad public needs. But Rather, I mean to emphasize and reinforce the Federal Reserve's long standing commitment to a credible course of moderate growth in money and credit which will support a continuing noninflationary economic expansion.

As for making the difficult but absolutely critical decisions that will resolve the budget stalemate, I have no easy answers, Al though the alternatives seem clear. We can cut spending or we can increase revenues, or we can do some of both. Deciding where to cut spending or how to increase revenues is not the province of the Federal Reserve. Such decisions are political in nature — in both the partisan sense and as they related to the will of all Americans. At its heart, it seems to me, the budget deficit issue is a referendum on the size and role of the government in our society. And the sooner this issue is resolved, the clearer will be the economic outlook.

In closing, I am encouraged about the sincerity and intensity of the public debate over the budget deficits. Given this debate, I am very hopeful that our political processes will soon produce ~~the~~ an appropriate solution--one which will enable our economy to move forward with renewed confidence on a path of sustainable growth. through the 1980's —