Economic Policy Issues

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Monetary Policy In 1985: Extending The 1984 Criteria

Last year's economic performance greatly exceeded even the most optimistic forecasts. Real growth averaged 6.8 percent, the best showing since 1951, while inflation (as measured by implicit GNP deflator) rose only 3.7 percent, the smallest increase since 1967. The dollar showed extraordinary strength throughout most of 1984; surprisingly, it rose to a new high toward year's end as the Fed eased monetary policy and U.S. interest rates declined sharply. (Declining U.S. interest rates had been expected to result in an easing of the value of the dollar.)

Despite last year's impressive economic performance (which included a decline in the unemployment rate to 7.1 percent), there remained three problems that carry over into 1985: (1) A severely depressed farm sector and a system of small banks in the farm belt that remains precariously exposed. (2) A record U.S. trade deficit of $123.3 billion in 1984—induced mainly by rapid U.S. growth and the strong dollar. (3) Persistent huge federal budget deficits despite the economic prosperity. Reducing the federal budget deficit probably will be the most important economic policy issue confronting President Reagan and the 99th Congress during the current year.

The main goals of monetary policy in 1984—sustainable real growth and preservation of price stability—are likely to continue dominating Federal Reserve policy in 1985. (See

As in former years, the first report in the 1985 series of *Economic Policy Issues* is devoted to analysis of monetary policy. To broaden the perspective of our own analysis, we again asked the President of a Federal Reserve Bank and three private-sector economists of different persuasions to provide brief assessments of last year's Federal Reserve policy and near-term prospects. Their contributions are gratefully acknowledged.

Roger Guffey, President of the Federal Reserve Bank of Kansas City, stresses that promoting sustainable growth is a prime goal of the Fed and preservation of price stability is its main contribution to this goal (pages 2-5). Michael Keran, Vice President and Chief Economist of the Prudential Insurance Company of America, and Ben E. Laden, Vice President and Chief Economist at T. Rowe Price Associates, Inc., assess Fed policy in 1984 and the propects for 1985 (pages 8-10). Peter I. Berman, Second Vice President/Investments with International Gold Corporation Ltd., considers economic implications and policy responses to a decline in the dollar (pages 11-12).

Steven R. Malin wrote our own analysis for this report.

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below for Roger Guffey's assessment.) The Fed appears to respond now with a lag of several months to large swings in the real economy. Specifically, unsustainably rapid real growth triggers monetary restraint, whereas a sharp slowdown in economic growth induces easing by the Fed. Money growth rates and the Federal Reserve's target ranges have come to serve merely as a "secondary guideline" for monetary policy, while international considerations received relatively little special attention last year.

Thus, in response to the extraordinarily rapid real growth (10.1 percent) during the first quarter of 1984, the Fed let market pressures drive up interest rates. Only when unsustainably vigorous growth continued through the second quarter (7.1 percent) and rapid money growth threatened to push the money supply above the Fed's target range, did monetary policy shift more forcefully toward restraint. As a result, interest rates escalated further until midyear.

When it became apparent that real growth was slowing drastically during the third quarter of 1984 while the money supply flattened out, the Fed responded with several moves toward monetary easing. Thus, a decline in interest rates triggered by the economic slowdown was quickly reinforced by an easier Federal Reserve policy. (In this connection, see Michael Keran's analysis in this report.)

In 1985, the Federal Reserve is likely to adhere to the same policy approach as in 1984. As long as economic growth proceeds at a moderate and sustainable pace, the Fed will continue to accommodate the economic expansion at relatively stable (or even declining) interest rates. Once the economy gathers momentum, the Fed initially will permit market forces to raise interest rates. Only if the pace of real growth threatens to become unsustainably strong is the Fed likely to shift toward active monetary restraint (driving interest rates higher in the process).

THE FEDERAL RESERVE'S ROLE IN PROMOTING ECONOMIC GROWTH

by Roger Guffey[1]

Each policy directive of the Federal Open Market Committee (FOMC) contains a statement of the goals of Federal Reserve monetary policy. One of those goals is to "promote growth in output on a sustainable basis." It has long been recognized that only through sustained economic growth can we improve living standards, increase job opportunities, and help to achieve other national economic priorities. In addition, several of our current economic problems—such as the international debt situation, the federal budget deficit, and the financial stress in agriculture and other important sectors—can best be managed in an environment of economic growth. For all these reasons, therefore, I believe sustained economic growth should be the preeminent long-run goal of economic policy.

What can the Federal Reserve contribute to achieving this goal? It should be recognized that the Federal Reserve's role in promoting economic growth is a limited but important one. It is limited because many factors outside the control of monetary policy influence economic growth. It is nonetheless important because the economy cannot realize its growth potential without reasonable price stability, which is largely within the control of monetary policy. In my view, therefore, the major contribution that monetary policy can make to sustained economic growth is to ensure reasonable price stability.

Not all would agree with this assessment. Some have argued, for example, that monetary policy can and should promote growth by keeping interest rates low. They reason that low interest rates encourage capital investment, thus raising productivity and economic growth.

The flaw in this argument is that capital investment depends on real interest rates, which are affected by monetary policy only in the very short run. It is true that easy money and credit can temporarily depress market interest rates. However, as soon as the inflationary con-

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Most economists project another year of strong, but sustainable, real growth (3.5 to 4 percent) with fairly stable prices for 1985. However, patterns of *quarterly volatility*—rather than the average annual growth rate—are likely to determine the Fed's policy responses in 1985 just as they did in 1984. Last year's forecasting record suggests that economists are ill-equipped to predict these quarterly swings. (Most economists projected relatively slow growth early in 1984 to be followed by much faster growth during the second half of that year!)

In 1985, international considerations are again expected to exert relatively little impact on Federal Reserve policy—except in the unlikely cases of an international financial crisis or a sharp drop in the value of the dollar. (See Peter Berman's assessment.) Yet, international considerations—including a further weakening of oil prices—could induce the Federal Reserve to impart to its monetary policy a slight downward bias with regard to U.S. interest rates. This would stimulate world economic growth and assist debt servicing by the less-developed countries. In case of a sharp drop in the value of the dollar, *temporary* Treasury-Federal Reserve intervention in the foreign exchange markets appears a distinct possibility.

Finally, what further can be said concerning the outlook for interest rates in 1985? The record of the 1960's and 1970's reveals that the third year of any sustained economic expansion always produced rising interest rates, whereas second-year patterns were much more diverse. (See chart on page 4.) Thus, historical patterns as well as the continuing high federal budget deficits suggest that strong real growth in 1985 should produce a pattern of rising interest rates later in the year. However, improved inflationary expectations could modify these historical patterns in 1985. The unusually saw-tooth pattern of interest rates in 1984—particularly the sharp declines after mid-year—indicate that financial-market experts have

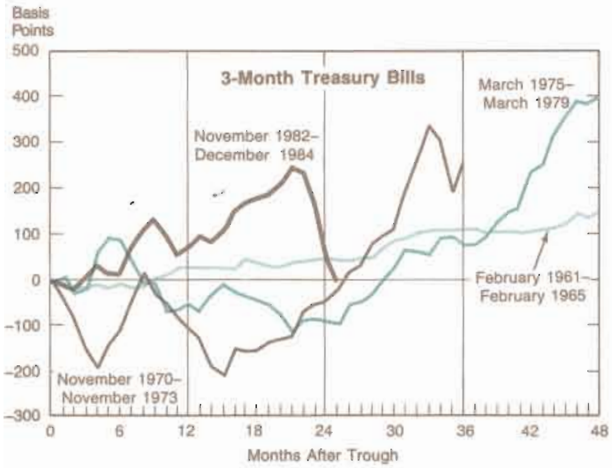
sequences are realized, the inflation premium in nominal rates rises, pushing market rates up enough to restore real rates to their previous levels. As a result, holding market rates down by inflationary growth of money and credit will not stimulate investment. Indeed, past experience suggests that by increasing uncertainty, inflation leads ultimately to higher interest rates and lower stock prices. Therefore, keeping market interest rates artificially low is at best ineffectual and at worst counterproductive in achieving sustainable economic growth.

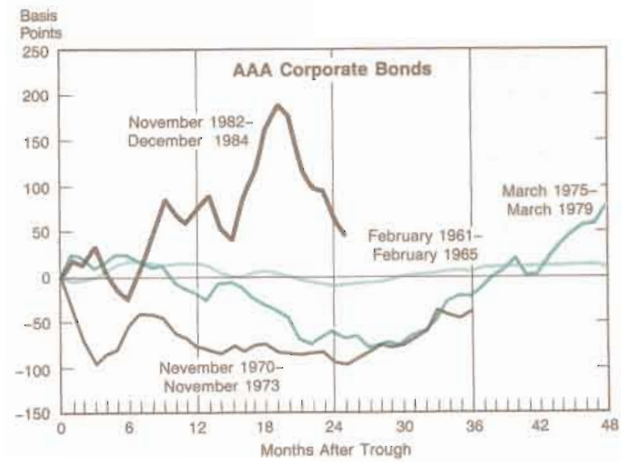
The need to focus on real rather than nominal interest rates demonstrates a more general principle—that economic growth is determined primarily by real factors rather than by credit conditions. The savings rate determines how much output can be devoted to investment; changes in technology and consumer preferences create profitable opportunities for capital investment; and investment increases productivity growth, which is the driving force behind sustained expansion in output. These real factors, not nominal interest rates, are the fundamental determinants of economic growth in the long run.

Nevertheless, economic policy has a role to play in promoting economic growth. Fiscal policy—the government's taxing and spending decisions—affects incentives for saving and investment. In this regard, I welcome the national debate stimulated by the Treasury Department's recent tax proposals. If a "flat tax," or some other tax system, would enhance incentives for economic growth, such a system should be given serious consideration. It would be unfortunate, however, if discussion of tax reform diverts attention from the most pressing fiscal issue—the budget deficit. With the Federal Government absorbing up to one-third of Private Sector savings, too little is left over for the productive investment necessary to sustain economic growth. Moreover, the high interest rates and strong dollar that have accompanied large budget deficits threaten to damage irreparably some domestic industries that could otherwise contribute to economic growth. Bringing down the budget deficit is the most important fiscal policy action that could be taken to improve prospects for balanced and sustained economic growth.

Monetary policy has a role, too. That role is to provide a stable financial environment for economic decision making. Such an environment requires stability not only of the financial system but also of the aggregate price level. Reasonable price stability is necessary to ensure that the market system efficiently allocates real resources to the productive sectors of the economy that drive economic growth.

Changes in Interest Rates During Economic Expansions





Sources: U.S. Treasury; Moody's Investor Service; The Conference Board.

reduced their inflation expectations. Since real U.S. interest rates remain at historically high levels while inflation continues to be subdued, further declines of both nominal and real interest rates during 1985 cannot be ruled out.

Michael E. Levy

It used to be thought that money was neutral in the long run because growth in productive capacity was independent of the inflation rate. But experience indicates otherwise. While economic growth is determined fundamentally by real factors, experience shows that inflation can depress real growth. In the 1960's, when inflation was low, output grew at a rate of about 4 percent a year. Since inflation began to accelerate in the early 1970's, though, real growth has slowed to less than 3 percent. To be sure, oil shocks and other real factors were partially responsible for this slowdown. But high and volatile inflation also contributed. Inflation created uncertainty, depressed capital investment, diverted resources from the real to the monetary sector, and impaired the efficiency of the market system. That experience taught us that the economy does not function well with high and volatile inflation. The experience also taught us that the Federal Reserve can best contribute to sustainable economic growth by fostering the expectation and the reality of a stable price level.

The long-run goal of achieving price stability has been the guiding force of monetary policy in recent years. The FOMC has sought to bring inflation down by gradually reducing the annual growth ranges for money and credit aggregates. Although regulatory changes and financial innovation have altered money demand relationships, and has thus required occasional adjustments in these ranges, the basic strategy has remained intact. This strategy of monetary restraint has led to substantial progress in reducing inflation from the double-digit rates recorded in the late 1970's.

Progress toward price stability in recent years has already improved the nation's economic performance. Lower inflation and the associated improvement in inflation expectations have boosted consumer and business confidence. This improved business confidence has been particularly important because it has created an environment conducive to a capital investment boom, which not only has added to the strength of the current expansion but also has raised future productive capacity. As a consequence, the Federal Reserve's policy of monetary restraint has already borne fruit in promoting long-run economic growth.

Experience in 1984 typifies the Federal Reserve's attitude toward money growth and inflation. When monetary-growth ranges were established in February of last year, FOMC members expected that growth within those ranges would be consistent with nominal GNP growth of 9 to 10 percent, divided about evenly between inflation and real growth. In the first half of the year, extremely rapid growth in nominal GNP

MONETARY POLICY CRITERIA, 1984-1985

Beginning in mid-1982, the Federal Reserve abandoned its single-minded anti-inflationary policy in favor of a more pragmatic approach, intended to reduce interest rates, stimulate the economy, and avoid domestic or international financial crises. (For a review of monetary policy in 1982 and 1983, see *Economic Policy Issues,* 1984, No. 1.) Under the Fed's revised approach, as long as inflation remained under control, policy decisions "would depend on evidence about the strength of the economic recovery, the outlook for prices and inflationary expectations, and emerging conditions in the domestic and international financial markets." (On two occasions—in the Spring and in the early Autumn of 1983—the Fed exercised its new flexibility by initiating moderate, though timely, adjustments in monetary policy—first by increasing, and then relaxing, restraint in the provision of reserves to the banking system. The purpose was partially to relieve international and domestic financial pressures that could seriously disrupt the economic recovery or price stability.)

Although 1983 ended with both the economic expansion and disinflation well intact, a continuing large federal budget deficit, high real interest rates, and the large and growing international trade deficit made continuation of U.S. prosperity in 1984 and beyond less assured. Massive Treasury financing in 1984 (estimated at between $170 and $190 billion) was expected to intensify normal cyclical pressures on nominal interest rates, and to raise real interest rates beyond already historically high levels. Throughout 1983, large differentials between U.S. and foreign real interest rates had attracted record inflows of foreign capital into the United States that helped to moderate pressures on U.S. financial markets, raise the value of the dollar, and control inflation. Yet a growing

threatened to intensify inflationary pressures and produce monetary growth above the announced targets. In response, increased pressure was applied on reserve positions of depository institutions, and the discount rate was increased. Some critics described these restrictive actions as being "anti-growth." To the contrary, such actions were designed to support sustainable real growth by preventing reacceleration of inflation. Indeed, as growth of money and spending slowed after midyear and it became apparent that inflationary pressures were being contained, the FOMC responded by reducing pressure on reserve positions and lowering the discount rate.

Economic developments last year were very favorable. Nominal GNP growth of about 9.5 percent was in line with FOMC expectations and was accompanied by growth of M-1 and M-2 near the midpoints of their ranges. Because of favorable supply-side developments—such as declining oil prices, a strong dollar, and continued moderation of labor costs—this GNP growth was associated with more rapid real growth and less inflation than initially anticipated. It is gratifying that larger output and employment gains were possible without producing incipient inflationary pressure that would ultimately undermine economic growth.

Looking ahead to 1985, I believe the approach to monetary policy should be similar to that of the past year. The announced ranges for monetary growth are consistent with continued economic expansion. Private forecasters predict real GNP growth of about 3.5 percent this year. Based on experience last year, I believe the Federal Reserve should be prepared to accommodate this, or even higher, real growth so long as it is not achieved at the price of a higher trend inflation rate. We do not know how rapidly the economy can grow in this third year of recovery without putting excess demands on labor and product markets. We do know that allowing such excess demands to persist will lead eventually to higher actual and expected inflation that would erode the foundation for sustainable growth. It would be irresponsible for the Federal Reserve to pursue such a myopic policy of allowing excess demands to persist. We did not do so last year and should not do so this year.

In summary, the nation's overall economic objectives can best be achieved within a framework of sustainable economic growth. For this reason, both monetary and fiscal policies should be aimed at achieving this laudable goal. The major contribution that monetary policy can make to sustained economic growth is to ensure reasonable price stability.