

As Review

The Prospects for Balanced Noninflationary Growth
in the U.S. Economy

Presentation to Denver Rotary Club

Roger Guffey
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~~Orange form~~
~~Thank Wayne Martin~~
~~Stu Moore~~

I. Introduction

Your kind invitation to meet with the Denver Rotary Club 31 today was indeed welcome. We at the Federal Reserve appreciate the opportunity to discuss the economic outlook and economic policy issues with business and professional people in Denver and elsewhere.

In my view, economic policy is now at a crossroads. ^{The Stage is Set for} ~~_____~~ a clash between monetary and fiscal policies that needs to be resolved as soon as possible. The Federal Reserve's ^{Monetary} policy ^(that management of the nation's money and credit) remains one of restraining growth of money and credit to prevent and inflationary expectations. But this restraint has run up against the massive credit demands of the federal government to finance the budget deficit. ^{as evidenced by}

Evidence of this clash is painfully apparent ^{real} high interest rates, ^{serious} a growing trade deficit, and imbalances in our economy. As a result of these imbalances, the health of agriculture and other important sectors has continued to worsen, and growth in the overall economy has slowed noticeably: over the past year or so.

Because of the high stakes involved, ^{as a nation} the economic policy choices we make in the next few years to resolve these imbalances will determine our prospects for lasting prosperity. But if we adopt policies that ^{just} treat the symptoms of our economic problems rather than the root causes, we could ^{seriously} ~~permanently~~ impair the efficiency of our economy ^{for years to come}.

Before discussing my views on the most desirable course for economic policy in the future, let me first review past policy mistakes and ^{substantial} the progress we have made in offsetting the effects of those mistakes in recent years.

II. Past Policy Mistakes

In my judgment, The biggest policy mistake we as a nation have made in the past 20 years was allowing inflation to accelerate ^{to double digit levels} in the late 1970s.

In retrospect, it is clear that the most damaging effect of accelerating inflation was the changes it brought about in attitudes. Americans ^{begin} ~~came~~ to think of high inflation as a natural part of economic life, and their behavior changed accordingly. We began to count on inflation to bail us out of bad business and investment decisions.

During that period, policies ^{designed} to combat inflation were ^{largely} ineffective--either because the policies themselves were flawed or because they were abandoned prematurely. The flawed policies included ^{such things as} direct government controls on wages, prices, and credit. We confirmed what we already should have known ^{That is,} you cannot legislate low inflation. Those policies that ^{might otherwise} ~~could~~ have been effective--fiscal and monetary discipline--were not pressed long enough to turn the tide, so inflation continued on an upward spiral.

As the 1970s drew to a close, the costs of inflation were becoming ^{all to clear.} ~~more~~ apparent. A declining dollar, low productivity growth, and erosion of business profits taught us that the economy doesn't work very well without a stable price level. There was also recognition that quick and painless solutions to the inflation problem were not possible, and that failure to face up to the ^{task} ~~job~~ would ultimately entail much higher costs.

Against this background ~~[of a need to deal decisively with inflation]~~, the Federal Reserve announced in October 1979 a new

program to ensure greater price stability. The centerpiece of the new program was a renewed commitment to restrain ~~the~~ the growth of money and credit. Through better control over the money supply, it was felt, we could help reverse the upward trend in actual and expected inflation. In retrospect, ^{the policy} ~~the program~~ of monetary restraint ^{Adopted by the Federal Reserve} has indeed been successful in reducing inflation from the double-digit rates of the late 1970s. And, as a result, the problem of accelerating inflation ^{at least for the present} is ~~now~~ largely behind us.

III. Effects of Monetary-Fiscal Imbalance

Unfortunately, this problem has been replaced by a new set of economic strains and imbalances. Interest-sensitive industries have had only a modest recovery from the 1981-82 recession--because interest rates have come down much slower than inflation. Moreover, our export and import-competing industries have fared even worse because of the extraordinary strength of the ^{U.S.} dollar.

Some blame the strong dollar, high interest rates, and most of the economy's other problems on overly restrictive monetary policy. A few members of Congress, for instance, accuse the Federal Reserve of putting the economy on a credit diet that will starve certain ^{important} sectors.

^{surely} However a ~~few~~ look at the facts ^{suggest otherwise.} Traditionally, total credit has grown at a rate about equal to nominal GNP growth. Throughout this economic expansion, however, credit has actually grown ^{much} faster than nominal GNP. Indeed, last year, credit growth was the highest in 40 years. This could hardly be described as ^{an} undue restraint on credit supplies.

Instead, ^{real} interest rates have remained high because of an explosion in credit demands. Private credit demands have strengthened substantially over the past 2 1/2 years, as is normal during a period of economic expansion. What is not normal, though, is the continued heavy borrowing by the federal government. Historically, the federal deficit shrinks rapidly as tax revenues grow during ^{the early phases of} an economic expansion. In contrast, the federal ^{budget} deficit has remained near \$200 billion throughout this recovery. As a result, the government must raise as much as \$4 billion ^{dollars} of new money/week in and week out in our money and capital markets.

Foreign Exchange markets, ^{also} ~~are~~, are affected by ^{these} fiscal developments. High ^{real} interest rates in the United States--caused by large budget deficits--forced up the exchange value of the dollar to record highs earlier this year. While the dollar has declined somewhat in recent months, it remains at such a high level that we are ^{in the period ahead,} bound to continue experiencing massive trade deficits. In essence, therefore, our trade deficit is the mirror image of the budget deficit. And, the growing trade deficit could have long-lasting implications, because the longer our exports remain depressed, the more difficult it will be ^{for 45 producers} to maintain marketing networks and ^{to} ~~recover~~ ^{their} foreign sales.

IV. Policies That Treat Symptoms

The need to reduce ^{the} ~~our~~ trade deficit is clear. But in striving to do so, there is a danger that Congress will adopt policies that we will all come to regret.

One such policy is for Congress to impose increased barriers to free international trade. For example, a proposal currently receiving serious consideration is an across-the-board increase in tariffs ^{money} on imported goods. Another is discriminatory tariffs ^{specifically directed} ~~to~~ Japanese goods. Some argue that ^{such} ~~these~~ tariffs would not only lower the trade deficit--by reducing the attractiveness of foreign goods ^{but ~~that~~ such tariffs} ~~but~~ would also help lower the budget deficit by increasing government revenues.

^{One has to ask whether} But ~~is~~ such a painless solution to our twin deficits really ^{is} possible? I don't believe so. By raising the cost of imported ^{goods} ~~products~~ and reducing ^{the} competition faced by ^{our} domestic producers, higher tariffs would raise the inflation rate, which we have paid so heavily to bring down. Moreover, lowering the trade deficit ^{in this manner} would ^{tend to} reduce the inflow of ~~foreign~~ capital ^{from abroad.} And, that would result in even less credit ^{being available to} the private sector and even higher interest rates ^{which would be necessary} to ration the limited supply of domestic credit.

To be sure, some domestic industries--such as the auto industry--^{might} ~~will~~ benefit ^{in the short run} by higher tariffs. But they would do so at the expense of higher interest rates and inflation that would ^{over time} reduce the long-run growth prospects for the economy as a whole.

Increased trade barriers also ^{would quite likely trigger} ~~could~~ invite a full-blown trade war. If higher tariff barriers are adopted by the United States, other countries would almost certainly follow suit by taking actions to restrict their imports ^{from the U.S.} As a result, U.S. agriculture and other industries that rely heavily on exports ^{sales} would suffer.

On the other hand,

Similarly, attempting to bring down interest and exchange rates by ^{following a more} expansionary monetary policy would be self-defeating ^{in my view.}

By feeding concerns about inflation, excessive monetary growth would likely raise rather than lower interest rates, especially long-term rates. Moreover, a depreciation of the dollar caused by inflationary policies would not, in the end, help our exporters because that depreciation would be accompanied by inflated domestic costs. We then would have ^{again} fueled the fires of inflation without having improved our trade balance.

In evaluating policies to achieve balanced economic growth, we should keep in mind two basic lessons from the experience of the 1970s. The first is that we cannot achieve lasting prosperity by inflationary growth of money and credit. The second is that ^{Just} gimmicks don't work. Trade barriers and similar policies only obscure underlying economic problems. The ^{borrowing more than we save online} fundamental problem is that we as a nation are consuming more than we produce. As a result, we face imbalances both in our government budget and in our international trade ^{Accounts} position.

V. The Need For Fiscal Restraint

What then can we do to resolve our internal and external imbalances? The only answer, it seems to me, is to make further progress in reducing the federal budget deficit. ^{Proposed} The spending cuts in the recently approved budget resolution are a useful first step toward fiscal discipline. However, even if adhered to in the appropriations process, these ^{Proposed} ^{still} cuts will ^{Projected} leave the deficit at levels that would have been unthinkable a few years ago--and that should be unacceptable now. Without further cuts in

in the years ahead

government spending or increases in tax revenues, the budget deficit will remain high enough to keep interest rates and exchange rates well above levels that are consistent with balanced economic growth.

I therefore conclude
~~that~~ that Congress and the Administration simply must find ways to reduce the deficit further, even if doing so requires politically unpopular actions. On the fiscal side, then, the next few years will be a time in which very hard choices must be made.

VI. The Federal Reserve's Contribution

as I indicated earlier,
~~but~~ easy money is no substitute for ^{these} hard choices. Money creation by the Federal Reserve cannot replace fiscal discipline as a basis for restoring a healthy balance to our economy. Rather, the greatest contribution the Federal Reserve can make to lasting prosperity is to foster the expectation--and the reality--of reasonable price stability.

This commitment to price stability doesn't mean that the Federal Reserve should adhere rigidly ^{to some magical} money growth targets in all cases. For example, when we initially set money growth ranges for ^{calendar book} this year in February, we thought that our target for the basic money supply, M1, was consistent with sustainable and noninflationary economic growth. However, because of an unexpected decline in monetary velocity--the rate at which money turns over, it became apparent that higher M1 growth would be required this year to support continued economic expansion. As a result, my colleagues and I on the FOMC decided to accept higher M1 growth ^{for the year as a whole.} Moreover, at our meeting ^{in July} last month, we adjusted the

July

M1 target range in a way ^{that} I believe will further contribute to continued economic ^{expansion} ~~growth~~. However, I want to stress that our accommodation of relatively high M1 growth this year should not be misinterpreted as a departure from our commitment to keep inflation down.

What does this ^{kind of monetary policy} policy imply for the economic outlook? With regard to the short-run outlook, I ^{believe earlier} ~~think~~ the declines in interest rates and exchange rates accompanying our relatively accommodative monetary policy ~~over the last several months~~ will lead to some pickup in economic growth in the second half of the year. I expect that growth in ^{consumer} spending will remain ^{relatively} moderate ~~and~~ but that more of this spending will be on U.S. goods, thereby boosting growth in domestic production.

The longer run outlook, however, depends on whether the ^{that I have described and that} imbalances ~~that~~ are now sapping the strength from our economy are corrected. Federal Reserve monetary policy cannot by itself correct these imbalances. All we can do is to try to achieve reasonable price stability, which is the necessary foundation for sustainable economic growth. Moreover, the economy's imbalances cannot be remedied by artificial trade barriers. Indeed, protectionism would ultimately make the distortions even worse. In my view, relief for the sectors adversely affected by high interest and exchange rates can only come from a more responsible fiscal policy.

In this regard, I remain optimistic that further progress can be made in reducing the federal budget deficits that are mortgaging the nation's economic future. The recently passed

for fiscal year 1986 and beyond

Proposed

may have

spending cuts suggest that a new consensus ~~has~~ emerged on the part of Congress, the President, and the American people for meaningful deficit reduction. Only by building on this consensus can we make further progress toward bringing down interest rates, exchange rates, and trade deficits over time.

VII. Conclusion

it seems to me that

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In summary, then, the American people and ~~their~~ elected representatives face politically difficult choices in the years ahead. However, we must not allow these political difficulties to serve as an excuse for postponing ^{further} needed fiscal discipline. Many otherwise healthy industries--including several in Colorado--cannot hang on much longer. I know that we as a ~~people~~ ^{nation} are courageous and ^{hopefully} wise enough to adopt ^{those} monetary and fiscal policies that will work together to achieve a lasting prosperity. And, given the importance of this effort--in terms of both our *own* domestic economy and ^{indeed} the world economy--we simply cannot afford to fail.

Thank you for your invitation to join you today and your attention.