Remarks by
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I am delighted to be here this evening to participate in the Foreign Policy Association Group meeting. I would like first to comment on the performance of the U.S. economy in 1995 and the outlook for this year, and then offer a somewhat longer-term perspective on the role of monetary policy in maintaining a noninflationary growth environment.

Following the robust expansion of the preceding two years, the U.S. economy experienced moderate growth in 1995. For the year as a whole, 1.8 million new payroll jobs were created. These job gains were sufficient to sustain the unemployment rate at around 5 1/2 percent, its lowest level in five years. At the same time, the country made further progress toward a noninflationary economy. Consumer prices rose only 2.5 percent in 1995, the fifth consecutive year inflation was around 3 percent or below.

Long-term interest rates declined sharply over the last year and, together with favorable earnings, this contributed to dramatic increases in equity prices. These financial developments reduced the cost of financing business investment and of buying homes and consumer goods. Consumer spending also benefited from substantial gains in household wealth due to rising bond and equity prices.

Despite this enviable record, the pattern of economic growth during 1995 was uneven. Real GDP growth decelerated considerably in the first half of the year before recovering to over 3 percent in the third quarter. Declining interest rates and a strong pick-up in housing activity helped pace that recovery. However, estimates released last Friday indicate that the economy experienced only about one percent GDP growth in the final quarter of 1995, though the underlying pace of growth is probably somewhat understated because of the partial government shutdown in mid-November and again in late December.

Data for December and early part of this year suggest a soft economy. But looking beyond the statistics, we seem to be growing at a moderate pace. While some recent indicators -- such as consumer confidence measures and purchasing managers' surveys -- suggest increased uncertainties about the outlook for consumer demand and business activity generally, my sense is that the recent weakness is likely to prove temporary. There is no evidence to suggest that the economy has slipped into a recession.

I believe the most likely scenario this year is for continued moderate economic growth. The low levels of long-term interest rates should support continued strong growth of business spending on plant and equipment, but perhaps at a slower pace than last year. Low interest rates also augur well for the housing market and for spending on consumer durables. Moreover, the accumulation of financial wealth resulting from the market's rise, which is now shared by a wider segment of households due to the spread of mutual fund investments, should help offset, at least to some extent, the depressing effects of rising debt burdens on consumer spending.

Chairman Greenspan, in Congressional testimony last week, noted that Federal Reserve policymakers anticipate moderate growth for 1996. The central tendency of the forecasts of Board members and Reserve Bank presidents is for real GDP growth of 2 to 2 1/4 percent on a fourth-quarter to fourth-quarter basis, and for the unemployment rate to remain at its recent level. Incidentally, the latest forecast by the Administration is similar.

My colleagues on the Federal Open Market Committee and I also anticipate that the good news on inflation will continue in 1996. With generally favorable prospects for labor costs and for prices of core production materials, conditions are not in place for much acceleration in consumer price inflation from its present level of somewhat below 3 percent.

I am convinced that much of our success in achieving this positive outlook and in containing inflation in recent years reflects monetary policy actions that pre-empted inflationary pressures. During the current cycle, the pre-emptive policy approach began in early 1994 when the Fed announced financial conditions in response to the buildup of underlying inflationary pressures which had not yet been reflected in actual price increases.

The main reason we need a pre-emptive approach is that monetary policy works with uncertain and long time lags. Estimates of these lags vary widely, but most of the effect of monetary policy on economic activity seems to take place within one to two years, and its impact on inflation usually takes even longer. Thus, I think the appropriate horizon for Federal Reserve policymakers is one to three years in the future.

The inflation experience of the last two decades has built up broad professional and public support for the need to achieve and maintain low inflation. Most elected officials, economists and the public have become much more aware that the economic and social costs of even moderate rates of inflation are quite substantial. These costs result from a variety of sources: the negative effects on long-term interest rates, reflecting inflation premiums; increased uncertainty about the outcome of business decisions; the perverse incentives to engage in activities aided by inflation and to forego others; distortions associated with the interaction between inflation and the tax system; and, more generally, the reduced efficiency and effectiveness of the price and market systems.

I also believe that inflation imposes a serious social cost because it falls particularly hard on the less fortunate in our society, the last to get employment and the first to lose it. These people do not have the economic clout to keep their real income streams steady, or even buy necessities, when a bout of inflation leads to a boom-bust cycle. As a consequence, they suffer disproportionately when the bust comes.

Against the background of generally low inflation and broad public support for policies that rigorously contain inflation, the recurring Congressional debate about the appropriate objectives of monetary policy has experienced a recent revival. Senator Mack of Florida has introduced a bill to make price stability the primary long-term goal of monetary policy and Congress is likely to hold hearings on this issue in coming months.

From my perspective, such a legislative mandate would help clarify monetary policy priorities and strengthen the Fed's commitment to price stability. By providing a long-term anchor for monetary policy, an explicit commitment to price stability also would help enhance the credibility of U.S. monetary policy, as well as its accountability.
There is no question in my mind that the primary long-term goal of monetary policy should be price stability, which is best defined as a situation in which inflation is not a consideration in household and business decisions. For me personally, this goal always has been the prism for making monetary policy choices.

With or without a formal legislative commitment, I am convinced that monetary policy must continue to aim at fostering sustainable economic growth, with inflation trending lower and, eventually, giving way to price stability. While recent price performance has brought us closer to functional price stability, I think we are not quite there yet. Inflation, as measured by standard price indexes, is now the lowest in a generation, but people still worry about its consequences and about the uncertainty of future prices. And these concerns influence their day-to-day spending, saving and investment decisions.

Many analysts seem to think that officially establishing price stability as the primary goal of monetary policy would mean the Federal Reserve would no longer be concerned about output or job growth, or that it would have no responsibility for coping with cyclical weakness of the economy. I believe that view to be simply wrong. Instead, a clear official mandate for price stability will reduce inflation premiums in long-term interest rates and enhance the capacity of monetary policy to counter occasions of cyclical weakness in the economy.

Some commentators also argue as if Federal Reserve policy aimed at containing inflationary pressures is tantamount to pursuing targets for real economic growth limited to 2 - 2 1/2 percent. The Fed, of course, has no such targets and, as recently noted by Chairman Greenspan, would welcome faster growth, provided that it is sustainable.

There is no simple or obvious relationship between real economic growth and inflation. In trying to determine the extent of future inflation, we must look at a variety of economic indicators, such as the unemployment rate and wage pressures, industrial capacity utilization, estimates of the gap between actual and potential GDP, developments in commodity prices and monetary aggregates, the extent of foreign competition, and the behavior of the yield curve. Some indicators have proven more useful than others, but unfortunately there is no straightforward summary measure that provides a reliable overall assessment of the many complex and diverse influences on inflation.

More fundamentally, I see no conflict between the goals of maximum sustainable real growth and price stability, despite what often is said and written to the contrary. The assumption that efforts to contain inflationary pressures will depress economic growth clearly is not borne out by historical experience. In the very short run, say within a year, expansionary monetary policy may stimulate the economy. But economists, in an amazing degree of accord in a profession which thrives on diversity, agree that higher wages and prices do not boost output and employment on a sustainable basis. Any temporary rise in output and employment is more than fully offset by the tightening of monetary policy to bring inflation back under control.

From a longer-term perspective, the economy's performance depends on a variety of technological, economic and social factors. But price and financial stability are key ingredients for enhancing economic growth. In fact, there is now mounting evidence that lower inflation leads to higher long-run growth. Recent empirical work finds not only a durable relationship between lower inflation and higher levels of GDP and productivity, but also suggests that lower rates of inflation are closely associated with faster growth rates of GDP and productivity. In particular, the post-World War II history of the U.S. indicates a strong and statistically robust negative correlation between inflation and real GDP growth, as well as between inflation and productivity growth.

Though statistical evidence has not yet established a causal relationship between inflation and either GDP or productivity growth, such a causal link seems entirely consistent with the various costs of inflation. In any event, I am persuaded that lower inflation almost certainly benefits long-run economic growth, even if it is not possible to pin down the precise numerical relationship. Only with long-run price stability can the economy expect to achieve the highest possible levels of productivity, real income, employment, and living standards.

As critical as monetary policy is for containing inflationary expectations and stabilizing the price level, it cannot ensure, by itself, economic and financial stability and maximum sustainable economic growth. For that, this nation also must do something about its significant structural problems. In particular, we continue to consume far too much and save too little to sustain a healthy economy over the long run. About the only effective way to increase the pool of savings available for investment is to reduce the federal deficit. I believe that a program to put the deficit on a downward path is absolutely indispensable for the long-run health of our economy.

In addressing the federal budget deficit and evaluating the effectiveness of various spending programs, we face some very difficult choices. I fully share the view that the overall economy works best with minimal government interference and that programs which don't work clearly need to be fixed. But fixing programs should not mean ending them, because so many of the societal needs addressed by government programs are real and, sadly, growing. Exposing individuals least able to compete to the whims of the markets raises serious social and fairness concerns.

Both the public and private sectors must be particularly careful not to shortchange investment in human capital, especially in the form of education and training. Such an approach would deepen the ongoing trend toward disparity between the have-s and have-nots. Over the last twenty years or so, advances in growth and prosperity have not been widely shared, and the less educated and poorer segments in our society have actually lost ground. Since 1973, real incomes for households in the bottom fifth of the population have fallen about 15 percent, while those in the top fifth have enjoyed real income gains of 25 percent.

Because of their negative effects on political and social cohesion, the widening disparities clearly are not conducive to a strong national economic performance. Over the long run, I believe, economic growth can be sustained only if the growing economic pie is shared by all parts of society -- rich and poor, urban and rural, skilled and less skilled -- people of all hues and all backgrounds. Only then will each of the varied parts of our society have a stake in its future economic development.

While the role of the public sector in creating jobs and economic opportunity is important, government action alone is not sufficient. Government efforts require the underlying support of the private sector. The role of private sector participants is all the more important today, in the face of the enormous pressures on federal, state and local governments to curtail their social welfare activities.

I encourage you to expand your efforts -- as both institutions and individuals -- to bring business and job opportunities to inner cities and other lower income communities. Each of us must do our part, in whatever manner we can. Only by working together to enhance economic opportunity for weaker segments of our society can we ensure sustained economic development of the entire society and our quality of life.

Thank you.