1986: WHAT WE KNOW, WHAT WE DON'T KNOW AND WHAT WE KNOW AIN'T SO
Remarks by Thomas C. Melzer
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I appreciate the opportunity to be with you today. Some months ago when I was asked to address the Society early in 1986, I thought it might be appropriate to discuss the Bank's outlook for the coming year. Now that the time has arrived, however, I question whether I should make any predictions. First of all, I'm not really confident of my prognostic abilities right now. I was convinced that the Cowboys and Raiders would win big last week. Of course, if football scores were treated like GNP numbers, both teams may in fact have won. Even if the "flash" estimates of the scores might look bad, with some appropriate data revisions and new seasonal adjustments, both could easily be winners.

The main reason for my reluctance is that uncertainties about prospective policy actions are greater this year than they have been in recent years. Consequently, our predictions have a longer-than-usual set of assumptions attached to them. Unfortunately, people typically remember predictions but forget the conditions underlying them. This is fine if your predictions come true; no one will notice that you were right for all the wrong reasons. But it is important to remember that predictions can be wrong for the right reasons; that the conditions--including policy actions--necessary to make them come true failed to materialize. With this stringent warning, I would like to talk about what we know and what we don't know for 1986.

Real Economic Growth and Employment There are a variety of factors that will influence real economic growth and employment in 1986. First, long-run trends in population growth and productivity have produced real GNP growth of about 3 percent per year for the past 90 years. This

long-run average rate of real growth allows the economy to absorb the growth in the labor force without significant increases in unemployment. Considering only these longer-run influences, we would expect real output to grow about 3 percent and unemployment to remain close to 7 percent in 1986.

The rapid money growth that we had in 1985 is a second influence on real output, at least for the first part of 1986. Based on our work at the Bank, accelerations in money growth typically precede faster economic growth, and decelerations in money growth typically precede economic slowdowns. The lag between significant changes in money growth and movements in real output is fairly short, about six to nine months. There was a considerable jump in money growth last year--it grew about 12 percent in 1985, up sharply from about 7 percent in 1984--and the impact of this surge in money growth on spending and output should spill over into the first part of this year. Adding to this positive but temporary influence on real output and employment during this year are the continuing declines in oil prices. Lower energy prices not only serve to restrain price increases in general, they also provide an impetus for increased production. Consequently, given what we know, real economic growth is likely to come in around 3.5 to 4.0 percent in 1986. As a result, the unemployment rate should drop slightly below its current 7.0 percent level.

But what about what we don't know? The two biggest unknowns that will affect the economy this year, and for years to come for that matter, are fiscal and monetary policy actions. Over longer periods, changes in government spending seem to have little effect on the economy; for shorter periods, however, such as two or three quarters, changes in government

expenditures have discernible effects on spending and output. There appears to be considerable confusion over what is likely to happen to government expenditures, especially in the light of Gramm-Rudman. Moreover, the confusion over tax reform makes it difficult to predict what is likely to happen to business investment. The possibility of future tax increases if Gramm-Rudman is constitutional, and government expenditures are not cut, makes investment predictions even more difficult.

If last year is any indication, monetary policy actions, at least as far as the growth of M1 is concerned, are also subject to considerable uncertainty. As you well know, there were two sets of monetary targets announced last year. Because money growth was so strong in the first part of the year, the first target was abandoned when it became clear that attempting to achieve it would have risked ending the current expansion. However, the second target, which ignored the rapid money growth in the first half and widened the permissible ranges, was not achieved either; money growth remained strong throughout the entire year.

Why did money grow so much faster than the Fed's targets? Primarily because of the unusual and unexpected behavior of velocity. The Fed's monetary targets were chosen under the assumption that growth in velocity--the ratio of spending to M1--would be positive during 1985. Instead, velocity plummeted. In the first half of 1985, velocity fell by more than 5 percent; in the second half, it declined by about 5.5 percent. Naturally, uncertainty over velocity movements raises two very different problems for predicting the economy in 1986. If money growth is slowed precipitously and velocity growth remains negative, there is considerable risk of a sluggish economy by the second half of this year. In this case, economic growth over the year would end up below what we expect.

On the other hand, if money growth remains fast and velocity growth increases, real output growth could well be stronger and unemployment even lower than I indicated. The basic problem is that there is considerable uncertainty over what velocity will do this year. Of course, two years of very fast money growth present other problems--primarily those related to price changes.

Inflation Which brings us to inflation. Again, there are a variety of factors that will influence prices during this year. First, there is the build-up in the underlying monetary pressure on prices. For nearly forty years, the key indicator of inflationary pressure was the long-run or trend growth in the narrow money stock, M1. Over the past three years, however, this relationship has broken down; while the trend growth (or three-year average growth) in M1 has risen to about 9.5 percent, inflation has remained flat at about 3.5 percent. If the historical relationship between trend money growth and inflation should begin to come back on line, even partially, higher inflation will again become a problem.

The falling value of the dollar in foreign exchange markets will, of course, compound any inflationary pressures. The lower-valued dollar not only makes imported goods more expensive, it also enables domestic producers to increase their prices as well. After all, they won't lose customers now that their foreign competitors' prices are also rising. So far, the value of the dollar has fallen 25 percent from its peak last February; continuing declines may add additional upward pressure on prices.

The only bright spot on the price horizon is the continuing decline in oil prices. However, even this bright spot is somewhat tarnished. Other commodity prices, which fell throughout most of last year, seem to

have turned around and have been rising fairly steadily since September. To what extent these increases in commodity prices will offset the influence of falling energy prices remains unclear.

What are the other major uncertainties in the inflation picture? The primary uncertainty is whether the money growth-inflation link will be re-established. Quite frankly, we don't know why this previously reliable link has broken down for the past three years. Consequently, we don't know if the breakdown is permanent or merely temporary. If the money-price link does not reappear in 1986, then inflation is likely to rise only slightly above what it was last year; the upward pull on prices generally exerted by the falling value of the dollar will be offset somewhat by declining energy prices. However, if trend money growth, once again, starts influencing prices, then the inflation rate could rise one to two percentage points above last year's rate by the end of 1986.

Interest Rates Turning to interest rates, I should note that I used to make my living at Morgan Stanley, in part, by capitalizing on interest rate movements. But, as a government trading manager, I never found it productive to make rate predictions. We were just as interested in making money on "aberrant" rate movements as we were on "real" or predicted ones. In any event, it is pretty well known that interest rates, over time, move closely with the expected rate of inflation. The problem lies, as I noted earlier, in predicting what the rate of inflation will do during 1986. If it rises only slightly, then interest rates are likely to remain unchanged from their current levels; however, if inflation begins to accelerate, interest rates, especially longer-term ones, will follow.

Of course, other factors also affect interest rates beside inflation; however, there is little that can be said currently, at least accurately, about what is likely to happen either to real interest rates or risk factors in 1986. In part, these are related to our uncertainties regarding the impacts of possible tax reform and the Gramm-Rudman legislation. While these factors are not likely to influence short-term rates much during 1986, they could play a major role in long-term interest rate movements.

Now, having warned you about the uncertainties inherent in predicting real output, inflation, and interest rates, there is one final warning I want to leave you with. This is a warning about what to consider when assessing various predictions made by other economic sooth-sayers. To paraphrase Will Rogers' well-known admonition, it isn't what we know that hurts, nor even what we don't know, it's what we know that ain't so that's the problem.

All predictions are based, presumably, on what we know, tempered, of course, by honestly acknowledging that there are some things that we don't know. However, many of the predictions that I have seen or heard recently appear to be based on premises that just "ain't so."

Let me give you just a few examples. There have been numerous comments recently that the reductions in deficits associated with Gramm-Rudman will decrease the fiscal stimulus and thus reduce economic growth in 1986 and thereafter. Now, we know that this is not the case. If deficits, by themselves, produced fiscal stimuli, where was the phenomenal growth in real output since 1981 during which time deficits ballooned to record levels? Since 1981, real GNP growth has been about

3 percent per year, roughly what it has been, on average, for the past 90 years. In fact, the $11 billion reduction in the deficit projected for 1986 is going to have no impact on real growth or employment. This same reasoning also denies that the reduction in deficits under Gramm-Rudman will require increased monetary stimulus to maintain real growth in the economy. Again, this just "ain't so."

Another example is the claim that the reductions in the deficit are likely to reduce interest rates, and, consequently, interest rates will decline due to the passage of Gramm-Rudman. This just "ain't so." The truth is that economists have been unable to find any substantive effects of deficits on interest rates at all. One could argue that Gramm-Rudman may have impacted inflationary expectations, and thus interest rates, by apparently reducing the risk of future monetization of government deficits. But, on the other hand, we must ask, with inflation presently at 4 to 4.5 percent, how much further could long-term rates fall regardless of this reduced future risk?

Finally, those who argue that our current account deficit has caused lower growth in output and higher unemployment forget that, in a flexible exchange rate regime, every dollar of that deficit must be invested in U.S. securities or equities; sellers of these securities spend the proceeds mostly on U.S. goods and services. Consequently, these dollars remain in the U.S. income stream and total economic activity is not reduced. Of course, there are some industries--export and import-competing--that will shrink, but other industries will take up the slack. Consequently, a fall in the value of the dollar and a reduction in the current account deficit cannot be viewed as stimulative.

On the other hand, expectations of a precipitous fall in the value of the dollar would dry up the foreign capital inflow, reduce the amount of credit supplied to U.S. markets, and cause upward pressure on U.S. interest rates. Therefore, if anything, international considerations would dictate a steady monetary policy rather than the alleged need to "ease" to produce further depreciation of the dollar and alleged stimulative effects on the economy.

The main point I would like to leave with you concerning economic predictions is simply this: they are a lot like New Year's resolutions. Some are based on good intentions, some are based on nothing substantive at all. They are announced loudly at the start of each year and quietly abandoned sometime thereafter. We all hope that no one remembers them clearly enough to remind us of our follies at the end of the year. So I promise not to remember your resolutions if you promise not to remember my predictions.