"THE ECONOMY IN 1990 AND BEYOND:
HOW FAR AHEAD CAN WE REALLY SEE?"

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I would like to thank you for inviting me to address this 16th meeting of the Northeast Mississippi Economic Symposium. When I was asked to speak to this large and distinguished group, I wondered what topic would be interesting for you to hear and reasonably safe for me to present. In the past, these considerations have always ruled out economic outlook talks. There are, after all, good reasons why thieves and forecasters should never return to the scene of their crimes.

You can imagine my surprise, therefore, when I received the announcement for this talk and discovered that I am supposed to prognosticate about "1990 and Beyond." My first thought was "Well, this is the last time I can safely visit Tupelo." However, because I would like to come back here in the future, I want you all to remember that I was forced to do this.

I should also warn you that I will focus exclusively on the influence of monetary policy on the outlook for the upcoming decade. This does not mean that other factors, such as fiscal policy actions and international events, are unimportant; they can and will play key roles in future developments. However, in all candor, I have no idea what these other factors will be and little expertise in forecasting what they are likely to be. Consequently, I will limit my comments solely to monetary policy considerations, chiefly because I think I know something about them.

So, what can we say about our prospects for 1990 and beyond? On the one hand, we know a lot about what we are likely to see next year. On the other hand, there are major uncertainties that make it extremely difficult, perhaps more difficult now than any time in the recent past, to know what to expect over the next several years. Therefore, I would like to spend a few minutes going over what we know about next year. Then I want to discuss the dangers that face anyone trying to take a longer look into the future of the U.S. economy.

The current expansion, which just turned seven years old, is the longest peacetime expansion in this nation's history. The "big" question that concerns us all is whether the expansion will continue into and through the 1990s. As you undoubtedly know, real economic growth has slowed in recent months; this is true whether you look at employment, industrial production or a variety of other broad measures of real economic activity. If we focus on why growth has slowed, we might get some perspective on how serious the present real economic slowdown is likely to be.

Historically, we have often seen temporary reductions in economic growth; the last time this happened was in 1986. Occasionally, these slowdowns are severe enough to trigger the death of an economic expansion. In the past, such periods of hesitation in real economic activity have been associated generally with adverse "real" or "monetary" shocks to the economy. For example, "real" shocks, in the form of sizable increases in energy prices, were clearly a primary factor in the recessions of the mid- and late 1970s. Likewise, "monetary" shocks, in the form of sharp slowing in the growth of the nation's money stock, have often been a primary or significant contributing factor in many economic slowdowns and recessions.

Over the past year, there has been a sharp reduction in the nation's monetary growth rate; so far this year, money growth has been only 0.2 percent at an annual rate. By comparison, it was 4.3 per cent in 1988 and 6.4 percent in 1987. If historical patterns are any guide to present circumstances, real economic growth is likely to slow and to remain slow for much of next year. We also know that, over longer time periods, monetary factors have little influence on real economic conditions; thus, the prospective economic slowdown, of whatever magnitude, will be only temporary. Moreover, the modest increase in money growth in recent months is likely to have a favorable influence on the extent of the economic slowdown; over the past six months, for example, money has grown at a 4.5 percent annual rate.

While slower economic growth is never good news for the economy, the inflation picture facing this country for the early part of the coming decade is much more appealing. A host of different things can affect various prices from day to day or even year to year. However, the single factor historically most responsible for general movements in prices is simply how fast the nation's money stock has been growing over several years. As I just described, there has been a continuing slowdown in money growth over the past three years. Actually, the extent of the reduction in monetary-induced pressures on prices is unprecedented in the post-World War II period. In the first quarter of 1987, the longer-term trend in money growth had almost reached 12 percent per year; as a result, we were not surprised that the inflation rate bottomed out in 1986 and started to push upwards. In contrast, this trend growth of money is now less than 5 percent per year. This sharp reduction in longer-run money growth has laid the foundation for declining inflation in the years ahead.

And, based on the historical evidence, we can expect market interest rates to mimic the general movements in inflation.

Now, what's wrong with this picture of temporarily slower economic growth and permanently lower inflation and lower market interest rates? Nothing at all, as far as it goes. The problem is that it really doesn't go far enough. This picture ignores several crucial issues that make the longer-run outlook considerably murkier than I have just described. The common thread that binds these issues is their possible influence on monetary policy decisions and, thereby, on the economy during 1990 and beyond.

What are these issues that are so potentially troublesome? First, whenever economic slowdowns occur, there is a predictable surge in public pressure on the Federal Reserve to "loosen up" on monetary policy. The chief problem is that, in the past, there have been times when the Federal Reserve gave in to these pressures; in those instances, monetary policy was directed solely toward short-run considerations, not long-term economic goals. The inevitable result was erratic monetary policy that exacerbated real economic swings while building in higher inflation. If this sounds somewhat familiar to you, it ought to; this is precisely what happened during the 1960s and 1970s.

Of course, the public never clamors for faster money growth *per se*. Instead, the popular call is for lower market interest rates; these, in turn, are presumed to encourage increased spending and economic activity. Faster monetary growth is viewed simply as the way to achieve this result. I'm sure I don't have to convince you that this view is strictly illusory; the inevitable longer-term result of faster money growth has always been an acceleration in inflation and even higher interest rates.

Another issue that has received increasing prominence in recent years, and will continue to do so in the upcoming decade, is this nation's trade deficit. The common notion is that we should reduce the trade deficit by exporting more and importing less. The presumed solution to this problem? Drive down the value of the dollar in foreign exchange markets, thereby making our goods cheaper to foreigners and their goods more expensive to us. How do we do this? I'm sure you can guess what the common answer is: once again, it is easier monetary policy.

Would easier monetary policy really solve our trade deficit problem? Not in any way that would be beneficial for this country. Easier monetary policy could drive down the "nominal" value of the dollar by producing higher inflation in the U.S. But if the dollar's value falls by, say, 10 percent while U.S. prices rise by 10 percent, where is the gain? Only movements in the dollar's "real" exchange rate--that is its "inflation-adjusted" value--influence trade. And, unfortunately, there is no evidence that monetary policy has any significant impact on real exchange rates. However, this point is generally overlooked when the public attempts to have the Federal Reserve boost exports by driving the dollar's value down.

The litany of reasons for easier monetary policy that we have considered represent implicit public pressure--from private citizens as well as from politicians--on the Federal Reserve System. Just how well the Fed withstands these pressures to abandon its longer-run policy goals for short-run economic "fixes" depends on a variety of factors. The historical record is mixed; it shows instances of both successes and failures. Whether the System will stand up to these pressures in the present instance, as economic growth slows, is an open question. Clearly,

whether or not it does so will have a significant influence on inflation, interest rates and other key economic variables in the upcoming decade.

There is, however, a "wild card" in the economic deck that could have even greater effects on what we will see in the 1990s than anything I have discussed so far. I am referring to recent attempts to introduce political considerations explicitly into the monetary policy process; one prime example of this is the Hamilton bill. I don't know whether any such proposed legislation dealing with the Federal Reserve will eventually be passed by Congress. However, I have no doubt that politicizing monetary policy in this fashion, if successful, will generate adverse consequences for this country in the years ahead.

The Federal Reserve System is now 75 years old. Back when the System was being created, there was deep mistrust, or at least deep suspicion, of what a central bank might do--especially one that was too closely connected with government. The Federal Reserve System, with its 12 regional banks and its Board of Governors in Washington, D.C., was the odd, innovative and uniquely American solution that arose from the political compromises of that time. Today, the United States remains one of the few nations in the world with a quasi-independent central bank.

Under the current arrangement, the people who make the monetary policy decisions--that is, the Federal Open Market Committee--are insulated--but neither isolated nor immune--from direct political pressures. Why is it important for monetary policy decisions to be insulated explicitly from political pressures? The key reason for such insulation is the difference in policy emphasis that such separation permits. It is a political "fact of life" that politicians generally must promise their constituents more and more benefits in order to be

elected. At the same time, these benefits must appear to be essentially costless. In other words, they must promise to spend more and tax less. Again, if this story sounds familiar, its resemblance to our current federal deficit situation is purely intentional.

One way to achieve this result, a way that has always tempted politicians, is simply to print more money. Of course, the term "printing more money" is a crude description for this activity. Usually, this process is called "keeping interest rates low," or "keeping our goods competitive in foreign markets," or, simply, "providing enough liquidity." Regardless of the label attached, however, this pressure always faces democratic governments and, as I pointed out earlier, their central banks as well. Only central banks that are relatively independent of the political process can resist these short-term political demands; only they can concentrate, instead, on the sole long-term goal that monetary policy can actually achieve--the goal of stable prices.

Does the closer connection between politics and monetary policy really make for bad results? The historical record tells us that the answer to this question is "Yes." It is all too easy to pick out examples of less-developed countries whose central banks are intimately intertwined with the political authorities; their failures to maintain even the semblance of reasonable price stability are well-documented. However, studies of the industrialized nations reveal the same pattern: countries whose central banks have less political independence (such as Spain, Italy and New Zealand) typically have higher inflation rates than those with greater central bank independence (like the U.S., Switzerland and West Germany).

It is important to understand that the notion of political independence does not mean that a central bank is not accountable for its actions. If anything, such independence strengthens the bank's accountability in terms of what it should actually be accountable for--namely, price stability. This is only possible when the central bank does not have to respond to every wiggle in the economy or every shift in the political winds.

Therefore, to return to my earlier warning, economic forecasts or outlooks for the 1990s--especially those for inflation and interest rates--are likely to be well off the mark if monetary policymakers succumb to public pressures that will accompany a slowdown in the economy. This problem would be exacerbated by the passage of legislation that would introduce explicit political considerations into monetary policy decisions or lessen the political independence of the Federal Reserve. Personally, I remain confident, or perhaps I should say hopeful, that neither of these will happen. Certainly, it would mean that I could return here with my outlook and my reputation for prognostication reasonably intact. More importantly, of course, it would mean that we had not thrown away the gains that we had made in the 1980s toward stable prices in the 1990s. And that would be the best outlook of all.