ECONOMIC OUTLOOK--SOUTHEAST U.S. AND THE NATION

Remarks by Thomas C. Melzer
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Good afternoon. I am delighted to participate in this Economic Outlook Conference and commend the School of Business Administration for initiating it. The nature of today's program and the support that it has attracted are positive reflections of the vibrant local economy you enjoy in the Jackson area.

Instead of providing a forecast, I have chosen to address my topic by sketching some of the important issues that will likely affect the national economy in 1991. Before you get too disappointed about not hearing my forecasts, let me relate the result of a study published in our Review some time ago. Twice each year The Wall Street Journal asks a panel of experts to forecast the level of short-term interest rates six months into the future. One of our economists examined these forecasts and found that not only were these experts way off the mark, but two-thirds of them guessed even the direction of change incorrectly. With results like this, it is not clear to me whether watching too much television or listening to too many economic forecasts is the greater danger to our society.

Just the same, there are important issues that will influence the economy next year. Moreover, the Federal Reserve is facing significant pressures from a variety of

groups to respond to these issues. True to the maverick reputation associated with the St. Louis Fed, however, my views on the keys to 1991's economic outlook and the appropriate policy responses differ from the conventional wisdom.

Before getting to what I think is likely to be the most important factor in economic performance next year, let me first deal with two issues that have dominated discussions of economic policy since mid-summer. Consider first the impact on the U.S. economy of the Middle East conflict and a doubling in the price of crude oil. The dominant view is that higher oil prices will reduce output and create inflation. If you limit yourself to very short time spans, you will see that output has fallen immediately following an oil price shock. And, without getting bogged down in a technical--albeit extremely important--distinction between inflation and a relative price change, it also has been true that the rate of change in standard price indices has increased when oil prices have risen.

But economic reasoning suggests, and the data support, the notion that these effects are short-run in nature and pose no significant risks to economic performance in the long run. Lest you doubt my lack of concern, consider the average rates of real growth and inflation for the eight quarters before and after the previous two negative oil price shocks, one in 1973-75 and the other in 1979-82. Looking at these data, you find only a slightly higher

inflation rate after the first oil shock and a sharply lower inflation rate after the second episode. Real growth actually shows slight increases in the trend rate after both oil shocks. These are not the sort of changes commentators have been telling us to expect.

Conversely, when the price of oil fell 65% during the first three quarters of 1986, the average rate of inflation increased marginally after the shock and output growth declined slightly. Overall, then, my skepticism is based not just on my inability to see the economic logic that suggests a doubling in the price of crude oil will cripple output or spawn another inflationary spiral. Rather, it is supported by data from previous episodes that clearly show the effects of an oil shock to be short-lived and, frequently, operating in the "wrong" direction.

Even if you concede my conclusion about the oil shock, many of you will move to the budget deal as the thing that will have a significant adverse effect on growth next year. But what will the budget deal accomplish? It will reduce spending in 1991 by $40 billion in a $5 trillion economy--that's eight-tenths of one percent! And it will raise tax revenues in a similarly microscopic range as a share of GNP. And, when all is said and done, the federal budget deficit next year will be larger, not smaller, than it has been in recent years. On another occasion we might

discuss the pros and cons of the income redistributions implied by the budget deal, but its effects on growth in the near term ought to be trivial.

If I am not worried about the consequences of higher oil prices or the budget deal, what does give me cause for concern? As someone involved in the policy process, I see now, perhaps more than at any other time in my experience, calls from all sides to ease, or tighten, or "do something" about the economic problems--real or imagined--facing us. With all of these pressures to confront multiple and conflicting objectives, the biggest risk to near-term economic performance in my mind is the potential for a significant policy mistake.

A recent anecdote may help clarify my thinking. My staff has just completed plans for our economic policy conference next fall; the topic is, "What do we know about business cycles?" A cynical colleague said "Oh, it will be a short conference." Cynicism aside, the comment does have some substance. In the last two decades, policymakers and economists have learned they have a great deal to be humble about.

But we do know some things, and in times of uncertainty, it is a great comfort to rely on what you know to be true. At the same time, we must be well aware of what we do not know. Policymakers should not have the luxury of gambling with other people's well-being by pursuing policies with highly uncertain outcomes. These two principles of

policymaking are extremely important now when it seems that virtually everyone wants an aggressive policy action of some sort.

What do we know? From a central banker's point of view, we know that the Federal Reserve has one policy tool--changing the quantity of reserves in the banking system. And, by simple accounting, it is limited to the pursuit, at a moment in time, of one policy objective. Moreover, we know from studying data from hundreds of years ago and from countries around the globe that there is one consistent and predictable consequence of monetary actions: increases in the quantity of money inevitably show up as increases in the price level. We also know that abrupt reductions in the quantity of money are associated with reductions in output in the short run. Finally, we know that when interest rates are "too high", the cause has been monetary policy that has been too easy rather than too tight.

Whether you attribute it to my modesty or my ignorance, I am content to end my list of policymakers' knowledge there. But even these limited precepts, I will argue, are adequate to deal with the year ahead. Indeed, to repeat my earlier warning, it is dangerous to conduct policy under the misguided belief that we know more than this.

My belief in the relationships between monetary actions and economic performance is supported by evidence on the current state of the economy. In 1985-86, the Federal

Reserve allowed itself to be re-directed from a goal of price stability to one of exchange rate targeting. Irrespective of how that policy of fast money growth might have affected the exchange rate, it was clear that it eventually would show up in the form of a rising trend rate of inflation. Indeed it has! We have seen the 3.5 percent average inflation rate of 1984-88 creep upward and now approach 6 percent.

Fortunately, the Fed saw the inflationary danger of this excessively expansionary policy and reversed course while Paul Volcker still was chairman of the Board of Governors. Alan Greenspan continued Mr. Volcker's move to tightening and, under his chairmanship, we have seen one of the most rapid reductions in the trend--or long-run--rate of money growth ever. This has very positive implications for future inflation. But, to support my view of how monetary actions work, this course has also been associated with a slowdown in real activity. Recognizing the differing lags between trend money growth and inflation on one hand and short-run money growth and output on the other, it is no surprise to me that the economy now exhibits an unfavorable mix of performance--rising inflation and extremely slow real growth.

At the same time, policy actions over the past 12 to 18 months have put both short-term and long-term money growth in a range of 3 to 4 percent annual rates, a policy stance I believe is consistent with both price stability and real

growth near the economy's potential. Still, people observe the poor current economic performance and ask the crucial question: Where do we go from here?

In contrast to my modest agenda for monetary policy, the public and the politicians have an ambitious program in mind. Because the oil shock is clearly inflationary to some observers, monetary tightening is in order. But, to others, the Fed must ease to prevent higher oil prices from throwing us into a recession. Further calls for ease come from those who have the new view that bigger deficits retard economic growth. Finally, because the dollar is weak, the Fed must do something to support it before it enters a free-fall. But we should not support it too much because exports would be hurt, and we need higher exports to prevent a recession.

Does your head hurt yet? After listening to all of this, "Change policy in this direction, but not too much," I sometimes wonder whether I am working for the Fed or Goldilocks. Nonetheless, let us see if we can use what we know and a few other basic ideas to work through these questions to some reasonable answers.

From my perspective, the Federal Reserve owns no oil wells and is not a significant user of oil. With no control over supply and little effect on demand, the Fed can do nothing to reverse the losses in wealth--or, more properly, redistributions of wealth--that have occurred since August 2nd.

With respect to the budget package, we should remember that fiscal actions of this sort reallocate--but do not destroy--resources, so that any losses of output will be temporary. Moreover, I am convinced we know so little about how the macroeconomy works that it would be extremely risky and the worst kind of fine-tuning to use monetary policy to attempt to offset whatever consequences the deficit may have.

But monetary policy can be used wisely and with little risk next year to build on a solid foundation for strong, noninflationary growth in the future. One of the things we know about monetary policy is that long-run movements in money growth are related to future inflation. Also, monetary policy has been successful in reducing the trend growth rate of the money supply from more than 11 percent to the neighborhood of 3 percent. Accordingly, I believe that by staying the course and resisting pressures to ease or tighten significantly from this position, the Fed has an opportunity to pave the way for a low-inflation, strong real growth economy in the years ahead. I know this point must be important because it gets virtually no discussion in the press.

In contrast, those who call for policy easing cannot tell me, with any certainty, its effect on output next year. But I can predict with confidence that accelerating the trend growth rate of money will produce an accelerating inflation and higher--not lower--nominal interest rates,

especially long rates. Conversely, those who call for more tightening of policy will be correct in their assessments of reducing inflation further--below the 4 to 5 percent range we have seen--but they cannot tell me, with any certainty, the cost of further tightening in the current slow growth economic environment.

With great uncertainty--and large potential costs--associated with many of the policy options now being discussed, I feel comfortable with a limited policy agenda. In fact, precisely because of these uncertainties and the relentless calls for aggressive action, monetary policy must focus on the one thing that it can accomplish--price stability--and resist pressures to pursue multiple, and conflicting, objectives.