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SEARCHING FOR A MONETARY STRATEGY FOR AN EXPANDING ECONOMY

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INTRODUCTION

The Commerce Department on April 18 announced its estimate that the Gross National Product grew during the first quarter of 1985 at a sluggish 1.3 percent in real terms. This preliminary figure shocked most economic forecasters, who were expecting a stronger showing. The flash estimate for the first quarter GNP, which was issued about a month ago, forecast a 2.1 percent growth in GNP, and it was widely assumed that the flash estimate would be revised upward when the preliminary appeared.

These anemic real GNP estimates call attention to the fact that there has been significant difference of opinion among analysts on the role of monetary policy. There are those who believe that monetary policy has been too tight, that the rate of money growth is too low, and that the U.S. needs a higher rate of money growth to assure a brisk and sustained economic expansion. There are others who argue that recent monetary growth rates are too high and that if they continue at this pace, they will reignite inflation. The weak first quarter growth highlights this debate over monetary policy, for it legitimately can be asked if the quarter's sluggishness reflects on money growth in 1984 and to what extent it reflects current monetary policy.

Throughout the Reagan Administration's first term, this debate was the subject of often acrimonious exchanges between Federal Reserve Board Chairman Paul Volcker, the Administration, and leading members of Congress. An examination of gold prices, commodity prices, and the surging dollar leads some analysts and

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politicians to conclude that the global demand for U.S. dollars is growing faster than the supply of money, hence forcing up interest rates and the dollar's value and exerting deflationary pressure on the U.S. economy. They believe that monetary policy should be more expansive.

A contrary view holds that monetary policy has been too expansive. Supporters of this position point out that in the last few months the money stock, as measured by M1, has been growing at rates exceeding 10 percent. This is much too high, they maintain, and if continued could lead to a significant acceleration in inflation.

A proper resolution of these conflicting policy prescriptions rests in large part on estimates of future economic growth. The economic outlook for 1985 appears very promising. Real output will likely expand at a rate of about 4.0 percent or more in the second or third quarter, and the average for the remaining three quarters could be 5 percent--a very strong showing.

The outlook for the U.S. economy for the remainder of this decade suggests a growth rate of approximately 4 percent. A somewhat higher rate of economic growth in 1985 and 1986 may be possible because of "catch-up"--the utilization of underutilized human and capital resources. But it is difficult to say how much more than 4 percent the economy can safely grow because of this catch-up.

The proponents of the high-growth option for the next few years argue for higher rates of money growth to facilitate the higher rates of economic growth, which they believe the economy can sustain, and which would cut unemployment and the deficit. The danger is, however, that money growth rates of 10 percent and more, such as the U.S. has experienced since November 1984, are likely to accelerate inflation. The high-growth approach could lead to a super boom in 1985 and a disastrous recession in 1986, followed by a new bout of inflation. Policy makers should not take this risk. Instead, they should aim for a moderate and sustainable rate of growth.

Such a moderate monetary strategy should aim at a growth in M1 of between 5 and 6 percent. This is sufficient for a 10 percent growth in nominal GNP or a 6 percent growth in real GNP. This strategy would allow for a reasonable margin of error. If the economy proved to be incapable of such real growth, the country might end up with a little more inflation. But by keeping the rate of monetary growth fixed at the 5 to 6 percent level, the damage from inflation would be limited. This strategy would avoid both the danger of underachieving--that, is of not letting the economy grow as rapidly as it could in a noninflationary manner--and the opposite danger of overstimulating the economy.

THE DEBATE OVER MONETARY POLICY

The nation's monetary policy is determined by the Federal Open Market Committee (FOMC) of the Federal Reserve System. The FOMC meets approximately once a month and determines the amount of reserves that the Federal Reserve will introduce into the banking system. The reserves available to the banking system determine the quantity of loans and deposits that the banks can offer to the public. Accordingly, decisions by the FOMC in conjunction with the banks and the public together determine the quantity of deposits. The basic stock of money--or M1--is equal to currency plus demand deposits plus other checkable deposits.

Monetary policy has become a major political issue in recent years because the money stock is a key instrument for determining the course of economic activity. There is overwhelming evidence that the money stock has an important influence on the nation's employment, production, income, and inflation rate. An expansionary monetary policy (a money stock growing rapidly) will stimulate the total, or "aggregate," demand for goods and services, while a restrictive monetary policy (a deceleration in money stock growth) will slow aggregate demand. By influencing aggregate demand, monetary policy is an important determinant of the nation's output.

There are several different views concerning the precise role of monetary policy, however. One is that monetary policy is too tight, that the demand for dollars has grown relative to the supply, and that the excessively restrictive monetary policy of the Federal Reserve System should be loosened. But another school of thought holds the opposite to be true, claiming that the money stock is growing too rapidly and that monetary policy is too expansive.

These radically different interpretations of current policy occur because there are deep differences of opinion over what are the relevant factors. Some observers look at the declining price of gold and conclude that monetary policy has been, and remains, too restrictive. Other observers examine the decline in commodity prices and reach a similar conclusion. Still others focus on interest rates. When they see rising short-term or long-term rates, they conclude that monetary policy is restrictive.

And finally, there are other observers who focus on the exchange rate. When the dollar gains in value relative to other currencies--especially when there is a rapid acceleration in the value of the dollar--they conclude that U.S. monetary policy is too tight. They base this on the thesis that, whenever the dollar appreciates significantly relative to other currencies, it is because of a refusal by the U.S. monetary authorities to meet growing world demand for dollars. These observers call for a more expansionary Federal Reserve policy with the goal of supplying dollars to foreigners to overcome what they see as a sharp rise in the global demand for dollars.

Other scholars and policy makers, however, conclude from the available data that monetary policy is too loose, not too tight. These observers look at the growth of money, and when they see the money stock--as measured by M1--growing at an annual rate of 10 percent or more, they are concerned. Why? They argue that, when the money stock is expanding at a 10 percent rate, it can finance a growth in Gross National Product (GNP), measured in money terms, of 13 percent or more. In the post-World War II period, these observers note, the rate at which each dollar turns over in the economy each year (known as the "velocity" and equal to the ratio of GNP to M1) has been increasing at a rate of more than 3 percent. Since the economy typically can expand real output or GNP at a rate of between 3 or 4 percent, a 13 percent growth in money or nominal GNP could theoretically bring about an inflation rate of 9 or 10 percent. Obviously, this would be an extremely worrisome development.

This analysis has assumed that velocity growth will be approximately 3 percent, or slightly over 3 percent, which is the average velocity growth rate since 1951. But it is very likely that the U.S. will experience some quarterly fluctuations in velocity. As GNP forecasts are developed, policy makers need to keep in mind that velocity growth in any particular quarter could be below one percent or as high as over 4 percent.

Some analysts are arguing that the Fed should accelerate money growth in order to offset an expected deceleration of velocity in 1985. The argument is that after several months of high rates of monetary growth--given the lag between money growth and spending--there is apt to be some slowdown in velocity. But this argument is not convincing. Although an acceleration in money growth is typically followed by a slowdown in velocity growth, this can hardly rationalize a policy of continuing high rates of money growth. Second, even if there were to be a slowdown in velocity in the next few months, reflecting the high money growth rates since November, other forces could raise velocity. If the economy were as strong in 1985 as seems likely, for instance, that could increase velocity.

THE ECONOMY TODAY--AN ASSESSMENT

The economy is still quite strong. A solid fourth quarter of 1984, with real GNP growing at a rate of about 4.3 percent, indicates growth that is impressive, even bordering on the high side. The GNP estimate for the first quarter of 1985, indicating only a 1.3 percent growth in real GNP and 5.3 percent increase in inflation, must be analyzed for the possibility of "overestimated" inflation and "underestimated" real output growth.

The indicators for 1985 look good. Because of the inventory adjustment, the second and third quarters likely will be considerably stronger. The nation has experienced rising production, rising total employment, some decline in the rate of unemployment,

a modest rise in inventories, and a declining inventory-to-sales ratio. This means that there is scope for significant rise in the growth of GNP later in the year as inventory restocking develops.

Prospects for the second and third quarters look very good. The urgent need is to formulate a monetary policy that will lead to the maximum output and employment that Americans can achieve, without igniting inflationary tendencies in the economy. This is a delicate task. There must be sufficient money growth--expansion in M1--to finance a healthy and vigorous economy. But money growth must be sufficiently modest to bring this about without reaccelerating inflation.

From June 1984 through November 1984 the money stock--as measured by M1--was relatively flat. There was practically no growth in M1 during this five-month period. Many believe that zero money growth for six months can produce a recession. The U.S. was fortunate there was no recession, although the third quarter of 1984 showed an extremely anemic growth of 1.6 percent in real GNP, and similarly for the 1.3 percent growth in the first quarter of 1985.

In the fourth quarter, the Federal Reserve sharply reversed course and since November 1984 money has been growing at a relatively robust rate. For example, from early November 1984 to March 1985 money growth has been averaging over 12 percent per annum. And from December to April money growth has been averaging over 10 percent--very much higher growth than the 4 to 7 percent M1 targets that the Federal Reserve presented to Congress.

In 1984 and 1985, the economy thus suffered an extremely roller coaster monetary policy. This was associated with a weak third quarter real GNP growth of 1.6 percent followed by a strong fourth quarter real GNP growth of 4.3 percent and a very weak first quarter growth for 1985 of 1.3 percent. The weak quarters were the direct consequence of the sharp deceleration and very low money growth from June to November 1984. A sharp deceleration and five months of very low growth were followed by five months of very fast growth in money. This is hardly the optimum monetary policy for stable economic growth, even though it may average out to 5 or 6 percent. It would be much better if the money stock had grown at a steady 5 to 6 percent rate rather than five months of famine, with very low growth, followed by five months of over 10 percent growth in money. Clearly, the behavior of the monetary authorities over this period was questionable, since the low money growth period in 1984 has now produced two very poor quarters, and a greater than 10 percent growth in M1 since November may well sow the seeds for inflationary troubles in the future.

THE FOUNDATIONS OF FUTURE POLICY

What then, given these recent growth figures, is the proper course for monetary policy for the rest of 1985? To arrive at a proper monetary target for 1985, two additional questions must be pondered. First, what average rate of economic growth is achievable for the remainder of this decade? And second, can the United States achieve an above-average, but still noninflationary, growth in the short run because of "catch-up" utilizing unemployed resources of labor and capital?

Economic Growth 1984-1990

The President's Council of Economic Advisers (CEA), in its Economic Report for 1985, outlines the determinants of total GNP growth in the U.S. for the remainder of the 1980s. The CEA estimates that real GNP in the United States can expand by about 4 percent from 1984 to 1990 and that this expansion can occur without any increase in inflation.

This view of growth potential is relatively optimistic. From 1948 until 1981, real GNP expanded at an average rate of 2.4 percent per year; and between 1981 and 1984, the real GNP growth rate was 2.7 percent. Thus, to assume that real GNP will expand at a rate of 3.9 percent for the period 1984-1990 is far from a low estimate.

To illustrate the optimism of the 4 percent rate, consider the forecast used by the Congressional Budget Office (CBO). In its baseline estimates, CBO makes the following assumptions: during 1985, GNP will grow at a rate of 3.5 percent; in 1986 at 3.2 percent; in 1987 at 3.3 percent, in 1988 at 3.4 percent, in 1989 at 3.4 percent and in 1990 at 3.4 percent. These CBO estimates are considerably lower than those of the CEA. The 1985 and 1986 CBO forecast is based on its analysis of the determinants of GNP in those two years; for 1987-1990, CBO derives its estimates for real GNP through a more complicated procedure that is based on analysis of growth rates from recessions in prior cycles.

So 4 percent could be considered the benchmark for an achievable U.S. growth rate for the remainder of the decade. In broad terms, this 4 percent rate of growth is made up of two factors: a labor force growth (man-hours) of approximately 2 percent and a productivity growth of approximately 2 percent. Adding the two leads to a 4 percent growth in output, sustainable without inflation. Factoring in the civilian noninstitutional population (age 16 and over) and the civilian labor force participation rate, an estimate of civilian employment can be obtained. And by making adjustments appropriate for the nonfarm business sector, for average weekly hours, for the productivity of the nonfarm business sector, and for the share of GNP derived from nonfarm business sector output, it is possible to derive an estimate for the course of real GNP for the period 1984-1990.

The CEA analysis suggests that the U.S. economy can expand at a 4 percent rate without setting off inflationary pressures. If 4 percent growth is the underlying capacity of the U.S. economy, given the country's labor and capital and other endowments, any attempt to expand at a rate consistently above 4 percent for an extended period would risk igniting inflationary fires.

The Possibility of "Catch-Up"

It might be possible to expand at a higher rate than 4 percent for a limited period. The CEA analysis assumes that the economy can expand at a 4 percent rate for the period 1984-1990 without incurring any inflationary risk. The CEA estimates already incorporate the use of catch-up over the period 1984-1990. But a question remains: If there is, indeed, excess capacity--if there are, in other words, significant quantities of unemployed labor or unemployed capital--it is possible to expand at an even faster rate for a limited period. Once the gap is closed, however, America must grow at the slower rate to avoid inflation. But until that point more rapid growth may be possible.

The unemployment rate in the U.S. is currently 7.3 percent. This study assumes that the noninflationary rate of unemployment is 6 percent (this is the unemployment rate consistent with not exacerbating inflation--or the nonaccelerating inflation rate of unemployment (NAIRU)). It is therefore possible to lower unemployment from 7.3 percent to 6 percent and still not run the risk of igniting inflation. There is thus a possibility of catch-up. But several steps are necessary to calculate the degree of possible extra growth beyond 4 percent.

What some analysts call the NAIRU corresponds to what others call the natural rate of unemployment--that is the rate of unemployment below which inflation accelerates. But there is no way of knowing precisely what the NAIRU is. Moreover, the NAIRU is not a constant, so it may be a different number in the future. Policies bringing about more flexibility in labor markets would achieve a reduction in NAIRU, and this would make possible even greater increases in real output. The NAIRU is assumed to be close to 6 percent at the present time.

Given the difference between the 7.3 percent unemployment rate and the 6 percent NAIRU rate, and assuming further that output can grow by an extra 1 percent for a one point reduction in unemployment, the implication is that the economy can grow at approximately an extra 1.3 percent for the next year, as unemployment is reduced from a 7.3 percent rate to a 6 percent rate. In other words, the nation's output can expand at approximately 5.3 percent for a year, while reducing the unemployment rate to 6 percent, without running a risk of igniting inflationary expectations. Suppose, however, it is possible to achieve a 2 percent increase in output for a one point reduction in unemployment. This assumption would suggest that output can expand an additional 2.6 percent (a total of 6.6 percent) for a 1 percent reduction in

unemployment. A similar analysis would suggest that if the unemployment rate is reduced from 7.3 percent to 6 percent over a period of two years, rather than one, national output can expand at a 5.3 percent rate for two years (if the ratio between an increase in output and a decline in unemployment is two), or by a 4.7 percent rate if the ratio is one.

Unfortunately, the ratio is not known precisely. So although it is possible to conclude that there is some scope for catch-up so long as unemployment is above the NAIRU, it is not known by how much more than 4 percent the economy can safely expand in the short run.

There is another complicating point: An expansion in aggregate demand can take two forms. One would lead to an increase in output and employment; the other would increase imports. To the extent that some of the increase in demand requires capacity that the country does not have, or that foreign goods are produced more competitively than domestic products, this additional demand will be filled by imports. On the other hand, to the extent that demand takes the form of goods that can be easily produced in this country, there will be additional domestic output. An expansion in aggregate demand thus may, or may not, be equivalent to an expansion in gross national product. It will depend on whether the demand is satisfied by foreign imports or whether it is satisfied by domestic production.

THE HIGH-GROWTH OPTION--BENEFITS VS. COSTS

There are many analysts today who advocate policies to quicken the pace of the U.S. economic expansion. They believe that faster money growth (that is, accelerating the growth in M1) would sustain a larger GNP, and a higher level of employment, income, and output. Whether the basis for higher growth is due to the Reagan Administration's tax cuts, to increased availability of labor and capital, or to increased confidence, the advocates of the high-growth option believe that the U.S. economy is capable of expanding at a rate of 5 percent or more--as measured by the real GNP. Accordingly, they are advocating a monetary policy that would facilitate and finance such a rate of expansion.

Those who favor the high-growth option arrive at this view in two distinct ways. Some believe that the achievable growth rate in the U.S. economy is above 4 percent. They, in effect, challenge and question the CEA analysis suggesting the 4 percent rate. Others who favor the high-growth option accept the CEA analysis but believe that for a year or two America can grow at a rate above 4 percent because of catch-up.

Catch-Up

While a growth rate above 4 percent for 1985 and 1986 may be possible by exploiting the temporary catch-up potential, there is

no evidence that the U.S. economy is capable of growing at a rate above 4 percent in the long term. Moreover, the available evidence suggests that the CEA's estimate of 4 percent growth for the remainder of the 1980s is on the whole an optimistic view and already incorporates some catch-up. Once the U.S. achieves full utilization of resources, it is highly questionable whether the economy can grow at a noninflationary rate above 4 percent.

Those who advocate policies to achieve a growth in the real gross national product of 5 percent or more for 1985 and 1986 imply that an unusually high growth rate is achievable. An expansion of 5 percent in real GNP for the next two years at this stage of the business cycle would be an extraordinary achievement. America is now in the 30th month of the recovery, and recoveries have typically averaged about 3 to 3½ years. Normally an advance in real GNP in the order of 3 to 3.5 percent could be expected at this stage in the recovery. This would be considered very good; an expansion of 5 percent or more for another year is certainly ambitious, and a 5 percent expansion for two or more years is even more ambitious.

Possible Advantages of a High-Growth Scenario

If successful, the high-growth policy would increase income, output, and total employment and probably lead to a more rapid reduction in the unemployment rate. The economy must expand at a 3 percent rate in real terms just to keep unemployment from rising, so that an expansion rate of 5 percent would cut into unemployment. The second major advantage of high growth, of course, is that it would result in larger increases in income and employment. And the third possible advantage is that it might be associated with an increase in productivity. Lastly, advocates of this strategy point out, it would help reduce the budget deficit. These are all clear-cut advantages, and it is not difficult to see why the high-growth option is so attractive.

Possible Disadvantages of the High-Growth Scenario

Clearly, if there were significant benefits and no risks associated with a high growth policy, it would command unanimous support. But policies typically have costs as well as benefits, and these have to be considered simultaneously.

The first cost of the high-growth scenario concerns the risk of inflation. Thus far in the recovery, the record on inflation has been extraordinarily good--in fact, much better than almost anyone expected. But part of this good inflation record is due to factors that may not continue. For example, the appreciation of the dollar serves as a powerful brake on inflation, as the resulting competition from lower priced imports exerts strong pressure on the prices of related and competitive domestic products, and also on domestic wage rates. Widespread declines in world commodity prices also have helped keep prices down in the U.S., but this cannot last indefinitely. Nor can the decline in

metals and energy prices, which has had a very beneficial effect on inflation in the U.S. Finally, the unemployment rate in the U.S., though declining significantly in this recovery, has still remained relatively high, and this too has been a factor in keeping down inflation by checking wage rates.

As the economy advances cyclically in this recovery and as unemployment declines, there is a smaller and smaller cushion of unused resources to prevent greater price increases. Recoveries have averaged about 36 to 40 months in the past and have typically ended because of bottlenecks, shortages, and imbalances associated with an upsurge in inflation. The bottom line is that as this recovery ages, there is the increasing risk that the pressure on resources could once again reignite inflationary forces.

Moreover, the danger of setting off U.S. inflationary forces increases sharply as policy makers try to quicken the pace of expansion. Experience shows that, even if real GNP is expanding at a 3 or 4 percent rate at this stage in the recovery, there is the danger that inflation will be ignited. But if policies are pursued to expand real GNP at a 5 or 6 percent rate, the risks of inflation increase enormously. Accordingly, a real danger of following the high-growth option is unleashing strong inflationary forces.

Should inflation accelerate, it would compound existing economic problems. Inflationary forces in the United States would reduce the global demand for dollars, which would in turn tend to weaken the dollar. Any weakening of the dollar would stimulate some dollar outflow, which would cause interest rates to rise. Moreover, any efforts by the authorities to protect against a major drop in the dollar would require a more restrictive monetary action to stop or reverse the outflow of dollars. This could lead to a spiral of higher and higher interest rates. Stopping this outflow of dollars could become extremely difficult, should the world develop doubts about America's ability to control inflation.

The Policy Dilemma

On the one hand, policy makers want to expand output to the greatest extent possible without increasing inflation. The goal is to achieve the highest rate of noninflationary economic expansion in order to reduce unemployment, to increase output and employment, and to reduce the budget deficit. On the other hand, a policy miscalculation could set off strong inflationary forces and thus undermine that goal. A policy mistake could easily cause the dollar to weaken and interest rates to rise. It could cause shortages and bottlenecks, which would kill the recovery and provoke a serious recession. A policy leading to a strong year in 1985 and a deep recession starting in 1986 is unacceptable. A much better policy is a steady one that seeks to prolong the recovery.

A FLEXIBLE STRATEGY

A prudent monetary strategy would avoid the horns of the dilemma. First, policy makers should avoid underachievement. If the real GNP is capable of growing at 5 percent without an increase in inflation, obviously it would be unproductive and inappropriate to be satisfied with 4 percent growth. Second, policy makers should avoid overstimulating the economy by engaging in expansionary policies that seek to expand real GNP to 5 percent or more, when in fact the economy cannot grow at more than 4 percent in a noninflationary way. Such excessive stimulation risks increasing inflation and interest rates, followed by a weakened dollar and a recession.

To achieve an appropriate balance, the policy of targeting the monetary aggregate makes sense.

The Federal Reserve could seek to achieve an average M1 growth rate of between 5 and 6 percent. Given the current behavior of velocity, such a money policy is consistent with a nominal GNP growth of between 9 and 10 percent. Assuming that the inflation rate remains at approximately 4 percent, this policy is consistent with a growth in the real GNP of 5 to 6 percent.

A monetary policy that targets M1 growth at 5 to 6 percent thus should provide enough money to finance real GNP growth of 6 percent, sufficient to achieve a steady reduction in unemployment. And yet this policy also would buy some insurance. Suppose that the economy is incapable of growing at 5 to 6 percent at a noninflationary rate--that it cannot grow more than 4.5 percent without exacerbating inflation. In that case the proposed monetary policy would lead to some escalation in inflation--possibly an increase from 4 to 5.5 percent--but the damage would be limited. A monetary policy that targeted M1 growth higher than 5 to 6 percent, however, could lead to a serious bout of rapidly increasing inflation.

CONCLUSION

If the economy is capable of 5 to 6 percent growth in real GNP, as those who favor the high-growth options believe, an M1 growth at 5 to 6 percent will do the job. If however, the economy is not capable of such growth in real GNP, this monetary policy will allow the inflation rate to accelerate some, but limit the damage. Such a policy strikes a good balance between the two risks--underachieving and overstimulating.

If policy makers really want to achieve a higher rate of real economic growth, changes in the economy will be necessary. Monetary policy can do little more than stimulate a short burst of new activity, not a long-term expansion. Such changes could include reforms in regulation, labor markets, antitrust laws, the education system, taxes, and environmental regulations designed to improve productivity and the allocation of resources.

To raise the rate of real economic growth, in other words, either the resources in the economy must be increased, or the available resources used more efficiently. Several steps could be taken to improve efficiency. For example, an additional cut in taxes which would increase the after-tax return, might release more resources to the economy. Reductions in regulations that interfere with productive capacity and hamper efficiency would improve allocative efficiency. Steps to enhance the mobility of labor and make labor markets more flexible would also help improve the allocation of that scarce resource. And improvements in basic education, by equipping America's youth with improved skills, would play a key role in promoting growth.

Such policies would raise the rate of economic growth by increasing and allocating resources more efficiently. It is tempting to believe, instead, that by gunning the printing press a little more, America will somehow achieve more real economic growth. This is a dangerous illusion--it will produce inflation, not prosperity.