Inflation in a Sluggish Economy — Trouble for Monetary Policy*

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I am very glad to have the opportunity to address this important gathering of the nation's savings bankers. Not surprisingly, my banking contacts tend to be primarily with the commercial banks of this District, since most of them are member banks of the Federal Reserve System. The System exercises a direct and powerful influence over their reserves for the purpose of carrying out national monetary policy. But while our relationship with your institutions is not as direct, we recognize that you play an important role in the national economy, especially where mortgage credit is concerned. We also recognize that the System's supervisory role and regulatory powers with respect to state member banks often take us into areas of direct interest to savings banks. So I welcome this chance to share with you a few thoughts on significant monetary problems that we face today. Before dealing with monetary policy as such, I would like to touch on a few questions bearing on your own industry.

I am sure you know that, while the first impact of monetary policy is felt by the commercial banks, savings institutions have also proven to be very vulnerable to tight credit restraint. The last five years have provided two significant testing periods: first, during the 1966 "credit crunch" and, more recently, during the even more severe restraint of 1969 and early 1970. During the 1966 episode, you may remember, the Federal Reserve System was prepared to use its emergency powers in order to assure a flow of credit to the thrift institutions. We were similarly prepared last summer had the need arisen. These experiences involving drastic curtailments of deposit inflows and the consequent strains on savings bank liquidity led to widespread suggestions that only fundamental changes in the way savings banks do business could rescue them from a situation that was not only unpleasant for them but which also created unnecessary handicaps for the smooth execution of monetary policy.

Even without fundamental changes, however, thrift institutions have shown remarkable ability in negotiating the difficulties of the past two years. They had the foresight to provide larger liquid reserves than had been customary in the past. In addition, during much of 1970 they have been able to realize a sizable increase in deposits despite the fact that competing investments have been yielding far higher rates than savings institutions are permitted to pay on deposits. Admittedly, mutual savings banks, located as they are near the eastern financial markets, felt most keenly the competition of market instruments and did not fare so well as other thrift institutions in this regard. Nevertheless, in recent months, deposit flows to mutual savings banks have also strengthened considerably. In any event, the recent deposit experience speaks well for the public's confidence in the safety of funds entrusted to the savings institutions and for their handling of customer relationships. Their success has borne fruit in the form of larger flows of mortgage funds and a better pickup in housing construction than credit conditions themselves might have suggested. I might add, however, that recent generous flows of savings to the thrift institutions are probably due in part to a temporary desire for safe harbor by consumers as they try to evaluate the uncertainties of world developments and the dilemma posed by the persistently rapid rate of inflation despite a sluggish economy and rising unemployment.

In any case, the fact remains that your organizations are highly dependent on one type of long-term asset which is none too well matched with your principal form of liability. It is thus no wonder that savings bankers have

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been turning their attention to possible ways of diversifying both assets and liabilities through a wider variety of customer services. The fact remains, too, that because of the enormous social significance and political influence of the housing industry, your activities have been the object of much attention on the part of various legislative bodies and regulatory authorities. Artificial ceilings on deposit interest rates have never struck me as consistent with a free enterprise system, but a major argument in their favor has of course involved the desire to protect the thrift institutions from some of the consequences of tight money that have followed from your specialization in mortgage financing while holding essentially short-term liabilities.

I would hope that basic changes in your industry might in time obviate the need for such artificial protection. One of the most fundamental of these, variable interest rate mortgages, has made very little headway—though I would add that it seems to offer some promise. Perhaps the propitious time for experimentation is now, when continuing high interest rates might give the proposal considerable public appeal.

Recent efforts to expand your activities—notably by adding checking deposits and the making of personal loans—have captured the interest and support of thrift institutions. A significant first step is the recent authorization granted to Federal savings and loan associations to make certain third-party transfers. I would agree that such moves carry considerable appeal from the standpoint of public convenience and need. On the other hand, I would stress that piecemeal modifications of the savings institutions' present rights and privileges probably do not give adequate consideration to questions of competitive equality among financial institutions (including even-handed tax treatment) or to questions of monetary policy. In the latter connection I should like to point out that, if the savings banks are to become a new source of demand deposits and hence to perform a full-fledged money-creating function, they must accept the likelihood that in due course they will become subject to the reserve requirements of the Federal Reserve if we are to avoid an undesirable weakening of the effectiveness of monetary policy instruments.

The type of difficult questions I have touched on so briefly will be solved only if all concerned will devote their best efforts to solving them. I have no doubt you yourselves will be in the forefront of this movement, and I can assure you that the subject is receiving much thought in the Federal Reserve; we also can hope for constructive suggestions from the Presidential Commission on Financial Structure.

Let's turn now to the part that monetary and fiscal policy have tried to play in promoting the nation's major economic goals: sustainable economic growth, high employment, reasonable price stability, and equilibrium in our international payments. Nearly two years ago I referred in a speech to a severe testing period through which monetary and fiscal policy would have to perform, to determine whether these broad impersonal methods of economic control could bring a halt to the inflationary spiral without subjecting the country to a serious recession. The testing continues and the answer is not yet apparent. By the time effective policies were marshaled against inflation in mid- and late 1968, inflationary psychology had become so deeply embedded that it was very hard to dent it, much less to dislodge it completely. Policy was successful in bringing about a pronounced slowdown of business—indeed, culminating in two quarters of negative real growth in the last quarter of 1969 and the first of 1970. Since then the rate of positive growth has been very modest, and unemployment has been climbing faster than most economists had predicted. Whether all this has constituted a recession is largely a matter of semantics; the essential point is that we have reached a range of unemployment which it would be socially undesirable and politically impracticable to exceed for any length of time. Yet on the other side of the picture we see continuing inflation, now almost entirely of the cost-push variety, with grossly excessive wage settlements the order of the day. These settlements are far in excess of any conceivable productivity gains and hence bound to contribute to either lower profits or higher prices, or both. Evidence of a slower trend of cost-of-living increases is still too fragmentary to be very convincing. And there is a constant danger that, if business picks up too rapidly, we may again see demand pressures reinforcing the cost-push in raising prices further. The evidence of recent years raises serious questions as to whether very low unemployment rates are compatible with a reasonable degree of price stability—particularly if such rates are approached through a rapid upswing in economic activity. As for inflationary psychology, it seems to me that most businessmen and most consumers tend toward a fatalistic view that prices are likely to go on rising substantially for a long time to come.

We should not lose sight of the fact that inflation not only produces gross inequities in our domestic economy, threatens sound economic expansion, and causes severe social losses, but it is also the greatest threat to restoration of a reasonable approximation to balance-of-payments equilibrium, with all that that implies for the dollar's international standing and world trade.

The Federal Reserve deserves high marks for its performance during the period of severe financial stress that developed in June and July. The System has shown that it can and will act effectively to prevent financial panic when this threatens as a result of tight money conditions and deterioration in corporate liquidity and corporate credit standards. The atmosphere of extreme uneasiness in financial markets during the early summer clearly called for decisive Federal Reserve action in an area that the market tends to forget for years at a time, i.e., in our function as lender of last resort. When the Penn Central collapse threatened to dry up much of the commercial paper market and thus to put great strains on major corporate borrowers, the Federal Reserve System moved promptly to assure the banks that reserves would be available at the discount window to enable them to fill the gap by providing bank loans. I am especially proud of the role played in this by my associate, William F. Treiber, First Vice President. And at about the same time the Board of Governors took the equally important step of removing the Regulation Q interest rate ceiling on certificates of deposit maturing in less than ninety days, thus providing the banks with a more lasting source of funds to serve the same purpose. The rest is now history. The commercial banks jumped into the breach with speed and effectiveness, and fears of some kind of general financial collapse soon vanished. Incidentally, the legacy of this episode is by no means all bad. Credit standards in the banks and investment markets are undoubtedly appreciably sounder now than they were six months ago.

On the whole, fiscal policy has performed reasonably well over the past two years or so. In fiscal 1969 and 1970, it contributed to the slowdown by eliminating the large deficit which had been recorded in fiscal 1968. While the present fiscal year's deficit threatens to be quite large, its size can be attributed in large part to a decline in revenues caused by greater than expected business weakness and consequent shortfalls in revenue estimates. To this extent the deficit is tolerable and it may even be helpful.

What troubles me most about the Federal budget is not the prospective deficit this fiscal year, but rather a feeling of unease as to the probable direction and magnitude of spending and revenues over the next several years. There are real hazards in placing excessive emphasis on the full-employment budget concept. Useful as that concept is, there are two cautionary notes with respect to its use: (1) the fact that a great many assumptions must be made concerning what constitutes "full employment" and concerning the course of real economic growth, prices, and tax revenues, all of which leave an enormous margin for error in the calculations of the full-employment surplus and (2) the fact that, regardless of the state of the full-employment budget at a given time, it is the actual budget deficit that must be financed. The deficit can have severe consequences both in terms of pressures in the financial markets and for the orderly provision of credit by the Federal Reserve.

As for the outlook for Federal spending, I am struck by the magnitude of the rise in nondefense outlays in the last year or two. It is only the sharp curtailment of defense spending that has permitted a rather good showing by total expenditures. With a number of important nondefense programs still in their infancy, there is a real risk of accelerating increases in these outlays over the coming years, while at the same time we may soon have exhausted the possibilities of large cuts in spending on defense. In addition, while agency financing outside the budget seems to be slackening this year as housing funds become more available, there is a large volume of potential financing by new as well as existing agencies on the more distant horizon. All of this has a bearing on whether fiscal restraint will be readily forthcoming if it should be needed again within the next year or two.

Meanwhile, what about monetary policy's present role? As I said earlier, some easing of credit conditions and provision of adequate liquidity during the summer's financial troubles constituted one important feature of our policy this year. But our overriding concern has been to encourage moderate expansion of money and bank credit to help the economy stage an orderly and gradual recovery. It is never possible to know exactly what rates of increase for these aggregates are most likely to bring the desired results, especially since the effects usually involve an uncertain lag. With respect to the money supply, some adjustment should be made for shifts in the public's desire to hold money balances—which is another way of saying that money velocity is bound to show unforeseen fluctuations from time to time. For example, the General Motors strike doubtlessly lessened the demand for money and credit and made it harder to induce a desired growth of money with a given injection of reserves into the banking system or a given set of conditions in the money market. I should also like to repeat a point that can hardly be overemphasized, i.e., it is always dangerous to set much store by short-term (say, month-to-month) swings in rates of gain for money or credit. These series are subject to so many unpredictable and uncontrollable influences, or later revisions, that a longer perspective is essential if valid conclusions are to be drawn from the figures. Even quarterly data may be subject to temporary distortions that should be discounted—not to mention the fact that the data may be substantially revised after the initial publication. The rather wholesale revision of the money supply data released about ten days ago is a case in point. Furthermore, the bank credit data must always be viewed in the light of the factors encouraging or discouraging intermediation of the banking system in the savings-investment process. A very high rate of bank credit growth was fully justified when withdrawal of buyers from the commercial paper market forced borrowers back into the banks. But fortunately a much slower rate of growth has reappeared since the commercial paper situation has pretty well stabilized.

I would not like to give the impression that the System is concerned only with the rates of growth of the money and credit aggregates. Early this year there was a change of emphasis in this direction, but no more than that, and we continue to regard credit conditions and interest rates as important considerations in the setting of policy. Of course, interest rates are influenced primarily by the size of investment demands and the volume of available savings; our ability to affect rates, especially long-term rates, is decidedly limited. For some time now, short-term interest rates have been moving sharply lower in response to slackened business activity and reduced loan demand along with an accommodative Federal Reserve policy. But until recently long-term rates, despite the sluggishness of business, were slow to respond under the influence of an enormous flow of new issues in the capital markets. The widening spread between short- and long-term rates appeared to be a natural result of supply and demand forces, and I have seen no need for special actions to push long rates lower. Within the last few weeks, in any case, long-term rates have also turned sharply lower.

While it has seemed reasonable and, indeed, essential for monetary policy to encourage moderate business expansion, there is no assurance that a policy of this type either will be consistent with checking the deeply embedded inflation or will keep unemployment within politically tolerable limits. We are not yet visibly winning in the test of monetary and fiscal policy—so it is in no way surprising that calls for further Government efforts to exert direct influence on wages and prices are heard in an ever-increasing crescendo. I was encouraged to note the Administration's recent initiative with respect to allowable oil production and import quotas, and the defeat of a protectionist trade bill would be an important step from an anti-inflation point of view. It is certainly true that past experiments with incomes policies, both here and abroad, have not been startling successes. Yet we really have little alternative but to keep on experimenting in this area hoping to find some reasonably acceptable and effective approach, not as a substitute for proper fiscal and monetary policies but as an additional support for them. A simple call for wage and price controls does not offer a practical solution. Those who advocate such an approach are often prone to forget the elaborate administrative trappings needed to make them work. Moreover, short of a wartime emergency, elaborate and rigid controls would probably not command sufficient public understanding and support. Yet I am hopeful that our ingenuity can devise some sort of workable incomes policy, whether backed by jawbone or some more tangible carrot or stick, that would command reasonable public support and would permit speedier progress against both unemployment and inflation. There may also be a need for a greater effort to reduce the social hardships associated with any given degree of unemployment, in order to reduce the seductive appeal of treatment by sharply accelerated increases in overall demand. I would like to emphasize that in any case I can see a great need for cautious fiscal and monetary policy as long as inflation remains the challenge that it is today. As savings bankers, you have as great a stake as anyone in the solution of this exasperatingly stubborn problem.