Testing Time for Monetary Policy

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I would like to talk to you today about the unusually difficult problem faced by monetary policy in the present setting of national and international economic conditions. There are always conflicting factors for the central bank to consider and weigh, but at most times during my years with the Fed it has been easier to resolve these conflicts than it is now. For one thing, there has usually been a clearer indication as to the relative risks of policies of expansion and restraint. At present the risks on both sides are very substantial. Also, while cyclical problems are always complicated by various long-term and structural factors, this complication is underlined today by the frightening magnitude of the energy crisis, with its wide-ranging influence on incomes, financial flows, and institutional arrangements. Thus it is more important than ever, in my judgment, that monetary policy, while maintaining its advantageous characteristic of flexibility, should move with the greatest caution in the months ahead.

Let me touch briefly on some of the key elements requiring our close attention. First of all, inflation continues at a rapid pace, not only in the United States but in almost all other major industrial countries. Despite the pressure of wage demands, as labor tries to make up for recent losses of real income, I can see real hope of a substantial reduction in the inflation rate during 1975, as most forecasters seem to agree. Sluggish business has already had a salutary impact on raw commodity prices, and this tendency should continue and spread through the economy as the business slack continues. This process could be helped along if more firms would respond to emerging excess capacity and increasing inventories with price reductions. Nevertheless, the really troublesome prospect is that the rate of inflation will still be unacceptably rapid when the economy starts on its next upward phase, with the possibility that it may then accelerate and reach new peaks in the next boom.

Meanwhile, we obviously must feel concerned with the deepening and pervasive recession that has developed in the last few months—with little hope of a pickup for at least another six months or so. We cannot be blind to the accompanying rise in unemployment, which seems likely to persist even for a considerable period after business begins to recover. Our concern must be heightened by the unfortunate distribution of unemployment by age, race, and geographical area. At the same time we should bear in mind that 7 percent unemployment does not mean 7 percent of the members of the labor force are permanently out of work. A large part of even today's sizable unemployment is frictional and of relatively short duration. The incidence of unemployment is constantly shifting as workers move into and out of jobs. Many of the unemployed, moreover, are secondary workers rather than primary breadwinners for their households. And the burden of temporary joblessness for many, though by no means all, unemployed workers is partially eased by unemployment compensation and in some cases by supplements provided under wage contracts.

I do not mean to suggest that unemployment never entails costs beyond minor inconveniences. On the contrary, it certainly imposes major hardships on some. In my view, however, these hardships should be mitigated by special relief measures—as is being done with extended unemployment benefits and temporary public jobs programs—rather than by excessive monetary stimulation, which can only make the goal of price stability even more remote. For the longer run, we should seek to reduce structural unemployment and to improve productivity by more effective vocational training programs, by the establishment of computer banks of information that might better direct available workers to available jobs, and perhaps by waivers of minimum wage requirements for young workers. Such reforms are needed not only to achieve a permanent reduction in the level of unemployment consistent with price stability, but also to ameliorate the social problems that arise from a lack of employment opportunities, especially among the young in our inner cities.

The central bank must be troubled, too, by the extent to which pessimistic sentiment has come to prevail among both businessmen and consumers. In my view, the pessimism is grossly exaggerated when warnings are voiced that we may be on the verge of a 1930's-type depression. Nevertheless, the current gloom is affecting the business outlook substantially, and it is mingled with a rather broad loss of faith in the ability of public authorities to cope with economic as well as political problems. The pessimistic talk frequently heard about the worthlessness of currencies in general is one symptom of this erosion of confidence, as is the sometimes rather desperate search for commodities or collectors' items that might serve as a store of value.

Another area demanding our attention is the financial stress we find today in our markets and institutions. Fortunately, some of the most acute market fears have faded as interest rates have fallen from their peaks of mid-1974. On the other hand, we cannot view with equanimity the evidence in many sectors of the economy that credit has been expanded too rapidly or unwisely. A long-declining stock market makes external equity financing difficult or impossible just when a strengthening of equity positions is needed most to offset the debt accumulation of recent years.

The most usual indicators of monetary policy are of course the money and credit aggregates, as well as interest rates. For the past year the narrowly defined money supply has grown at a moderate pace, considerably below that of 1973 and substantially below the too rapid rate of 1972. Growth was very slow in the third quarter of last year and, while it recovered somewhat in the fourth quarter, the growth rate had not then reached the level of the first half. As we have emphasized so often, growth rates of money over short periods are not only very difficult to influence but are of relatively little economic significance. It is also well to bear in mind that the statistical measurement of the money supply is far from an exact science, and is subject to frequent revisions besides conceptual difficulties as to what types of bank deposits should be included. For example, as more and more savings deposits are made withdrawable by check or draft, the line between M_1 and M_2 becomes more and more blurred. The System has always paid attention to both measures, but it may be that M_2 will deserve growing attention in the future. It is also worth stressing that velocity of money, as well as the supply of money, is a variable having important effects on the economy.

The role of interest rates in connection with monetary policy is a multiple one. Since the level of short-term interest rates has a strong influence on the speed of money growth, some short-term rates—and especially the Federal funds rate—play a major part in the day-to-day execution of policy. At the same time, movements of both short and long rates may have pronounced economic effects as, for example, on the health of the housing industry, the burden of financing inventories, the level of stock prices, and even the viability of the various markets for debt instruments. Thus the central bank can never afford to neglect the interest rate repercussions of its decisions, even though it would be rare indeed for the authorities to have any precise objective in terms of the level of interest rates. Last summer there was no rejoicing in the System when short-term rates reached record-high levels, but credit demands were then so heavy that any effort to reduce interest rates would have carried an acute risk of too rapid credit and money growth. Indeed, by exciting further inflationary expectations already clearly embedded in the high levels of rates, any attempt to hold down rates by massive injections of money and credit could well have been counterproductive. More recently we have welcomed the easing of interest rates from the abnormal levels of last summer in view of the slowing of credit demands, at least in short-term markets; and, with the easing of credit demands, monetary policy has been able to contribute to the rate declines by some deliberate easing without recourse to unduly rapid monetary and credit expansion.

In deciding how monetary policy might best be used in the current setting, it is important to distinguish between cyclical factors and longer term economic tendencies. Also it goes without saying that monetary policy cannot do the whole job, that it must take cognizance of—and adjust itself to—other official policies and especially fiscal policy. On the first point, most elements in the current domestic scene point to the likelihood of a cyclical recovery—though perhaps a rather gradual one—beginning some time after the middle of this year. With recession deepening until then, and unemployment rising, it would seem logical to apply a relatively stimulative policy to insure against the recovery's being aborted. But, while the rate of inflation will probably decline as a result of the recession, I can see no real hope that it will drop this year to a level that would have been considered satisfactory only a few years ago, for the present inflation is much more than a purely cyclical phenomenon. An overly rapid recovery of business from the prospective cyclical trough might very well lead to even higher inflation rates in the next boom than we have seen in this cycle, with all that that might imply for even deeper recession and even higher unemployment in the following cyclical period of business weakness.

Rising consumer expectations in almost all countries have undoubtedly been an important longer term cause of inflation, and now this factor is reinforced by the energy crisis. In a sense the rising expectations and high energy costs are on a collision course, for the much higher oil price means a large transfer of wealth from the industrialized oil-importing countries to the oil-producing countries, and thus a slowing or even cessation of the rising trend in living standards in the oil-importing areas until such time as productivity gains can recover enough to permit a resumption of gains in living standards. Unless this truth is recognized in political circles, there will be continuing pressure to try to restore living standards by providing larger supplies of money, even if the effort is doomed to failure and will merely add to the forces of inflation. Just to narrow the focus for a minute to the more immediate setting, there is an understandable desire now on the part of the American workers to make up for losses of real income in the past year or two. Yet overall productivity is still stagnant or declining, so that wage increases are almost sure to be translated promptly into higher prices. To be sure, this process could be prevented through a cut in corporate profits. It must be recognized, however, that corporate profits as a share of national income are at a historically low level already, and would be even lower if they were restated to reflect a more realistic evaluation of inflation's impact on inventories, depreciation, and other elements in corporate accounts.

It follows from what I have said that inflation must remain at least as important a consideration in central bank policy decisions as recession, with all that that requires in the way of avoiding any flooding of the economy with excessive monetary ease. But unfortunately this country's economic and political traditions are such that pressures for excessive easing in the present recessionary setting may become very strong indeed.

As I have already suggested, higher productivity is one major area that offers hope of some escape from the dilemma I have outlined. And higher productivity depends in considerable measure on continuing large capital expenditures. It is at least encouraging to reflect that the oil payment flows can be turned to good account in one respect if the accumulation of capital in the hands of oil-producing countries is effectively channeled into productive investment in the United States and other industrialized countries. Efforts in this direction would clearly be worthwhile.

I have spoken earlier of the financial strains that have been commanding our attention and that will continue to do so for some months to come. The Federal Reserve's role as "lender of last resort" has been rightly emphasized in many pronouncements over the past year or so, and highlighted by the successful handling of the Franklin National Bank's problems. In this connection, I might note that it was encouraging to me to see over the weekend that the commercial banking system has resources within itself to resolve a problem bank situation without the need of financial assistance from the Federal Government other than limited use of the discount window. Nevertheless, it seems to me well to note that by its nature the central bank is a short-term lender rather than a provider of longer term capital. Moreover, our ties are very direct with the banking system, somewhat less direct with other financial institutions, and even less direct with industry and commerce in general. For these reasons I can see real merit in an examination of the need for some new form of public institution designed primarily to provide capital to corporations suffering unusual financial stress or corporations engaged in programs of great importance to the solution of major national problems, such as energy and transportation, when adequate capital is not obtainable from private sources.

I spoke earlier of the need to mesh monetary policy appropriately with fiscal policy. I have recently, and somewhat reluctantly, come to the conclusion that we will have to have some easing of fiscal policy this year, preferably in the form of a tax cut. I say reluctantly, because I believe that fiscal policy has generally been too expansionary over much of the past decade. Coupled with the pressures it has put on monetary policy to be too expansionary at times, it has been a significant source of our underlying inflationary problem. Nevertheless, I believe that in today's world the sort of economic weakness we face this year does call for some positive action on the fiscal front.

The program proposed by President Ford in the State of the Union message is intended to provide such action. Since most parts of the program require Congressional approval, the Congress will doubtless make at least some changes in the program before it is enacted. Therefore, rather than comment in detail on the President's proposals, or upon any alternatives that might be brewing in the Congress, I shall merely mention a few general principles that appeal to me with respect to fiscal action. First, any net tax cut (that is, net of any increase in energy taxes) should be clearly understood to be readily reversible, so that we do not lock ourselves permanently into an overly stimulative and inflationary fiscal policy. Second, I believe at least part of the tax cut should be simple in structure so that it can be put in place promptly to cope with the recession now when stimulus is urgently needed. Third, I believe the cut should be directed at both individual and business incomes—the latter because the need to stimulate investment is clear. Fourth, I think the net size of the tax reduction should be held to moderate proportions, yet large enough to have a significant impact on consumer and business sentiment. Finally, I think we have to be careful that the Federal Reserve does not find itself inadvertently financing the enlarged Federal deficit by an undue increase in the rate of reserve expansion. Obviously, monetary policy should not offset the effects of additional fiscal stimulus by becoming less expansionary than would otherwise have been appropriate. On the other hand, it should not be deflected for any protracted period from progress toward the long-run goal of moderate monetary and credit expansion consistent with reasonable price stability. Within these guidelines, I think a new move to fiscal stimulus can serve a useful purpose at this time in cushioning economic weakness without threatening progress on the price front.

There are ample reasons from almost all points of view for this country and the oil-importing world generally to pursue a vigorous energy policy, with special emphasis on conservation of energy, designed to reduce gross oil payments and net oil deficits. It is gratifying that the Administration has been willing to propose a comprehensive program to this end. It would be beyond my competence to comment on the specifics of the energy program, but it does seem important to weigh the implications of steep boosts in fuel taxes for the general price level. In any case, the need for a thoroughgoing energy policy is compelling even though it could have some adverse initial effects on certain sectors of the economy. I am optimistic that the American people are coming to appreciate the vital need to get on with such a program, even though it may—and probably must—involve some considerable sacrifices.

Finally, let me stress the ever-growing interdependence of our world, and hence the ever-present need to take international factors into account in determining monetary policy. For example, we cannot overlook the significance of exchange rate developments in the setting for policy, and especially the inflationary effects in the United States of a sharply depreciating dollar. We must share with monetary authorities abroad a mutual concern for financial mishaps that could reverberate beyond national borders; the solvency of the Euro-banking system is one such matter of mutual concern. More generally, granted that domestic needs must always have first priority, the time is long past when we or other nations could pursue domestic goals without thinking of the effects policies might have in terms of international money flows and international economic relations in general. Progress toward a better alignment of monetary policies among leading countries, therefore, should have a high priority, even though such progress may be halting and fragmentary for some years to come. We will need to keep this objective in mind, as we cope with the exceedingly complex problem of adjusting national monetary policies to the needs of a radically changing world.

I have, I am afraid, pointed to a host of problems and pressures that now confront us: inflation, recession, unemployment, and energy, as well as strains in our domestic and international financial markets. But a full recognition of these problems is necessary before we can try to find reasonable and sound solutions for them. The recent and prospective international meetings to discuss the economic and financial response to the high cost of fuel, and the Administration and Congressional proposals to deal with our domestic economy, show that we are ready to begin the process. Each of us has a part to play in arriving at the best solutions and in applying them.