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Two Key Issues of Monetary Policy

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TWO KEY ISSUES OF MONETARY POLICY

I intend to focus this morning on two problems that concern practically all of our countries. We have just experienced an international monetary crisis, the ultimate repercussions of which are not yet clear. We shall therefore need to exchange ideas on how to deal with large short-term capital flows in the future.

The other major problem that haunts industrialized countries is the power and persistence of cost-push inflation. Let us turn to this at once.

Virtually all industrialized countries are suffering from inflation at present. In some, aggregate demand for goods and services is still booming, so that a rising price level can be expected. In others, however, costs and prices are continuing to advance in the face of substantial unemployment and increasing idle capacity of industrial plant.

We are living in an age in which cost-push inflation has emerged as a major obstacle to economic stability. Unless we find workable solutions to this problem, our best efforts to promote economic progress and the general welfare may be thwarted.

Clearly, countries that are now experiencing demand-pull inflation must pursue monetary and fiscal policies that aim to eliminate excess demand. But they may well find, as others have, that elimination of excess demand does not assure a prompt return to price stability.

The recent experience of the United States is a case in point. During the past year and a half, our unemployment rate has risen from 3-1/2 per cent to about 6 per cent. Labor is now readily available across the range of skills and in most sections of the country. Virtually all industries have substantial amounts of excess capacity. In such circumstances, past experience would have led us to expect a substantial reduction in the rate of increase of costs and prices, if not actual declines. In fact, however, the improvement thus far has been modest.

True, we have made progress over this past year in regaining normal rates of growth in productivity. However, increases in average compensation per manhour have shown no sign of abatement, and the advance of unit labor costs has therefore moderated less than we had hoped. With profit margins remaining very low, businessmen have taken available opportunities to pass their cost increases through to higher prices.

The continuance of a rising price level in the midst of substantial unemployment thus stems, basically, from continuing rapid increase in wages. Understandably, workers are seeking to obtain wage gains large enough to offset the effects of past increases in prices on their real incomes and savings, but this development also reflects the weakening of competitive forces in both our labor and product markets. Wages and prices have not been responding as sensitively as they once did to shifts in the balance between supply and demand.

The American economy is not unique in this respect. The problem of cost-push inflation has been plaguing many nations in recent years. In Canada, for example, unemployment began rising in 1966, and has been increasing irregularly since then. New wage settlements under collective bargaining agreements, however, have yet to show any appreciable sign of moderation. In the United Kingdom, the unemployment rate has been slowly rising over the past five years or so. Nonetheless, the upward movement of wages and prices appears to have accelerated in the past eighteen months.

Cost-push inflation cannot be dealt with effectively by using monetary and fiscal tools alone. In today's environment, efforts to do so would inevitably reduce output and employment far beyond the limits that our governments can accept or their citizens tolerate. On the other hand, I fear that cost pressures may become so intractable in our countries that they will ultimately weaken democratic institutions, besides stifling economic progress.

Over a year ago, I reluctantly came to the conclusion that monetary and fiscal instruments needed to be supplemented for a time by incomes policies in the United States--that is, policies designed to enable labor and commodity markets to approximate more closely the competitive model. My conviction has been strengthened by developments during the past year.

I recognize that governmental involvement in the determination of wages and prices can give rise to inequities, to misallocation of

resources, to the blunting of private initiative, and to an administrative morass, but I am also aware of the moral force of governmental leadership over private decisions in key industries, to say nothing of the capacity of a vigilant government to remove or reduce the special market power that privileged groups now have.

We need in the United States, and I believe also in other countries, greater reliance on policies that promise to change the structure and functioning of labor and product markets, so that upward pressures on costs and prices may be reduced. To cope with the inflationary bias presently at work in our economies, I see no acceptable alternative to experimentation with incomes policies--including wage and price review boards that stop short of mandatory controls.

Let me turn next to the problem posed by massive short-term capital movements. Recently, as we all know, heavy speculation in favor of a few currencies has led to changes in the exchange-rate regimes of several countries. It may be helpful to say a few words about the background of these events before asking what we can learn from the crisis we have been through.

The heavy flow of short-term funds from Europe to the United States in 1968-69 and the return flow during the past year resulted from a disparity in the phasing of the business cycle in the two areas. The United States experienced serious demand-pull inflation, and also moved to combat it, before Europe did. More recently,

while demand conditions have remained strong in Europe, we in the United States have sought to prevent a sluggish economy from slipping into a cumulative recession.

Differences in economic and credit conditions thus account for the swings in short-term capital flows of recent years. In particular, the flow across the Atlantic since early 1970 reflected not only a push from the United States but a pull from Europe. The push from the United States resulted from the easing of our credit conditions. The pull from Europe was just as clearly the result of a continuing demand for Euro-dollars by corporations and governmental entities that sought to escape from tight credit within their domestic markets.

It was against this background of a massive return of short-term capital to Europe in 1970-71 that speculative fever broke out a few weeks ago. Oddly enough, there were good reasons to believe that we had already passed the peak of capital flow.

The U. S. Government issue of three billion dollars in special securities to foreign branches of American banks had served to check the flow of dollars to European central banks. After mid-March, a convergence of interest rates got under way, with short-term rates rising in the United States and declining in Europe. By April the repayment by U. S. banks to their foreign branches had slowed sharply. Not only that, steps were already being taken to check the creation of Euro-dollars by European central banks which had inadvertently,

but on a disconcertingly large scale, added to the dollar reserves that resulted from the balance-of-payments deficit of the United States. In addition, major plans were being developed by the U. S. Treasury to provide improved investment outlets for central bank reserves in the United States.

Unhappily, the calm that appeared to exist in these unfolding circumstances was disrupted by various events in Europe with which you are all familiar.

The events of the past two weeks have left a residue of resentment among European countries and toward the United States. If some of you feel that the United States depended excessively on monetary ease in the past year, there are surely grounds for holding that European countries relied excessively on monetary stringency during this period.

I must remind you of two facts. First, the United States recently resorted to a far more restrictive policy to wring excess demand out of its economy than any country in the world, with the possible exception of Canada. Second, if a cumulative recession had been allowed to occur in the United States, it would almost certainly have brought serious economic and political trouble to other nations of the free world.

Let me turn briefly now to several lessons we can derive from recent events.

First, in a world of convertible currencies, with many business firms and financial institutions commanding large sums, differences in monetary conditions can induce sizable movements of short-term capital among nations. Let us recognize that such flows are the result of a pull from the receiving countries as well as a push from the capital exporting countries.

Second, the amplitude of short-term capital movements will become smaller if we manage to reduce differences in monetary conditions. This would require, in all major countries, a more active use of fiscal policy for domestic stabilization purposes. The political obstacles here are formidable but, I hope, not insurmountable. We should keep this goal before our minds as we deal with day-to-day problems.

Third, the Euro-currency markets no doubt facilitate the international movement of short-term capital, but let us not deceive ourselves regarding cause and effect. The flow of funds through these markets is a response to differences in basic economic and monetary conditions among countries, not a cause of such differences.

Fourth, some industrialized countries lack the facilities to neutralize the disruptive effects of large capital inflows or outflows on their domestic money supply. It is important that we all press forward, individually and jointly with other nations, in devising institutions that may serve to reduce the destabilizing impact of short-term capital flows.

Fifth, we live in a world in which private citizens and businesses are expected to act in response to the profit motive. Central banks, on the other hand, have a stabilizing function that should not be influenced by considerations of profit or loss. If central banks are to respond to the same factors that motivate private entities, they are likely to aggravate their own problems, as happened during the past year when a significant volume of central bank reserves was placed in the Euro-dollar market.

Sixth, there is a tendency in some quarters to identify the U. S. balance of payments as the common cause of inflation in other countries. I recognize that the flow of short-term capital has had the effect, to some degree, of undermining monetary policies in some countries. But let us not exaggerate this effect. The wage explosions experienced by European countries in recent years cannot be attributed to the U. S. balance of payments.

Seventh, what I have just said represents in no sense an attitude of complacency about the U. S. balance of payments. In a recent appearance before a Senate committee, I stressed once again the overriding need to restore price stability at home and, in present circumstances, to maintain our governmental constraints on private capital outflows. I also took that occasion to note the need to develop more effective methods for recycling funds across national boundaries when substantial short-term capital flows occur, the need for some countries to relax their restrictions on commodity imports and capital

outflows, and the need for America's allies to make a significantly larger contribution to the defense of the free world.

In closing, I would like to repeat what I told the Senate Banking Committee about the prospects for the U. S. balance of payments. I see no reason for gloom about these prospects.

Our price performance has recently been better than that of many other industrial countries. This advantage is likely to continue and it should permit us to regain competitive strength that we probably lost in the second half of the 1960's.

Our receipts of investment income from abroad have been rising rapidly. We expect this to continue even as rewards from investment at home, which affect both our capital and current accounts, loom larger.

We have seen in recent years a large increase of foreign investment in the U. S. stock market. This too should continue, provided we maintain a strong and healthy economy and take measures to prevent recurrences of the sort of speculative crisis that occurred recently.

The reduction of our troops in Vietnam is diminishing the military drain on our balance of payments. We expect this reduction to continue.

Finally, the bulk of the short-term capital outflow through our banks is now behind us. American banks have reduced the liabilities to their foreign branches from over \$14 billion in early 1970 to less than \$2 billion presently. Thus, even before our underlying payments

position improves, our deficit on the official settlements basis should fall sharply from its rate of the last year or so.

These favorable prospects can be hastened if they are accommodated to by other countries. After all, the counterpart of the U. S. deficit is the rest of the world's surplus. We and our major trading partners need to respect, in a spirit of candor and understanding, the policy implications of this simple arithmetic truism.