Inflation: A Test of Stabilization Policy*

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This annual luncheon at the New York State Bankers Association midwinter meeting always brings a welcome opportunity to share my thoughts with you on major developments of the past year and on prospects for the new year.

As I have reflected on my comments in the last few years, I have been struck by the persistence—or recurrence—of the same old problems year after year. In early 1967, for example, while recognizing that there was a good deal of concern in the business and financial community over a possible recession, I found the forecast of a serious recession unconvincing. I was, on balance, more worried over a slippage in our efforts to combat cost and price pressures—especially in the light of the urgent need for an improved trade surplus to remedy our weak balance-of-payments position. One striking difference at that time from the present situation was the fact that credit pressures had already slackened and interest rates had declined; these factors were stimulative to domestic business, but at the same time suggested trouble with respect to international capital flows.

Today I would like to adopt a little longer perspective, and take a look at the major policy problems that have beset us ever since the overheating of the economy that was sparked by the stepped-up Vietnam war effort in mid-1965. Perhaps there are some lessons to be learned from that experience that could be useful as we face a difficult future and as the Congress faces an urgent need for decisions on fiscal policy. As background, there had long been a pervading concern—a national preoccupation—about recession. Any recession—even a mild one—was the greatest possible evil to be avoided at all costs. On the other hand, inflation had often been looked on as an inevitable phenomenon of modern economic life that was more annoying than devastating. Doubtless because of deeply embedded memories of long years of depression, we have had a kind of national passion for rapid growth at all costs.

Of course, since 1965 the overriding problem has been how to check inflation by using the relatively impersonal stabilization weapons of monetary and fiscal policy. Apart from all the domestic implications of this problem, there always lurked in the background the nagging difficulty of our balance of payments—the problem of how to preserve the dollar's key position in the world by getting close to payments equilibrium without jeopardizing the role of the United States as a "natural" exporter of capital and without using methods that would upset the whole international financial system. Thus we were never able to take decisions for domestic reasons without regard to their international effects.

First let's have a look at the contribution of fiscal policy in the period under review, and then turn to monetary policy. By 1965 the theory of using fiscal policy as a deliberate stabilizer had become pretty well accepted—certainly in academic circles, and probably very largely in business and Government circles. But alas, theory and practice were very far apart. In the first place, timeliness would seem to be a first requisite of an effective fiscal policy. Yet from late 1965, when the need for higher tax rates to combat excessive demand first became apparent to many of us, two and a half years passed before significant action was at last taken in mid-1968. At first the Administration was reluctant to push for restraint on the fiscal front, and then an unpersuaded Congress took a year and a half to go along with the Administration's urgings. And by that time inflation was well out of hand.

The Administration's hesitation in 1966 seemed to re-

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flect a lack of awareness of the extent to which stepped-up military outlays might be expected to bring an excessive total demand in the economy, or at best an insistence on documentary proof that such influences were already being felt rather than a willingness to act on the basis of reasonable expectations. Even when the extent of the demand pressures was realized, there seemed to be a reluctance to go to the Congress for the tax increase needed to carry out a military commitment that commanded less than wholehearted popular support.

In the Congress, one very important element was the insistence of some legislators that taxes should be raised only if adequate cuts in spending were assured. However defensible this view might be, it had a paralyzing effect on timely tax action. For one thing, it depended on the establishment of spending priorities—inevitably a long and argumentative process. And there were some who automatically opposed an increase in taxes because they thought an increase would merely permit and assure a commensurate rise in spending. This, to me, was simply a counsel of despair.

Equally damaging to effective use of the tax instrument was the later injection of the debate over tax reform. Without denying the great importance of tax reform, I find it hard to avoid the feeling that this debate diverted attention from the more pressing question of establishing income tax rates appropriate to the economic circumstances. It seems clear to me that maintenance of a 10 percent surtax rate through the present fiscal year, and perhaps longer, would have been desirable from the anti-inflation point of view.

Admittedly, questions of economic analysis and judgment also entered into the tortuous history of the tax surcharge. Even while the inflation was gathering momentum, there was much reluctance to try to slow the economy by fiscal means. My testimony before the House Ways and Means Committee in September 1967 included the following sentence: "I do not share the fear, frequently expressed in these hearings, that a 10 percent tax rise could dip the country into recession." We can all recall the misplaced fears of economic "overkill" at the time when the surtax was at last enacted in mid-1968. And lingering sentiments of a similar kind doubtless had something to do with the decision in early 1969 to propose reducing the surtax rate to 5 percent on January 1, 1970 and eliminating it as of July 1, 1970. These judgments gave too much weight to the risks of a possible recession and too little weight to the immediate problem of inflation.

Effective use of fiscal policy in these years was also weakened by a quite different line of argument—that of the monetarists who find an almost surefire mechanical relationship between changes in the money supply (subject to some variations in definitions) and subsequent changes in gross national product. There is no doubt that the monetarist school has performed a useful service by focusing public attention on the importance of money and credit aggregates. But since the monetarist view in its most extreme form denied any significant role to fiscal policy, it is not surprising that some people who were loath to increase taxes in any case seized on this view as a sophisticated justification for inaction.

On a less sophisticated level, use of fiscal policy as a deliberate weapon against inflation has always suffered from lack of grass-roots understanding of the relationship between higher taxes and price stability. I feel strongly that we have not done a good educational job in explaining, in simple terms, how fiscal and monetary policies are expected to function. For example, there is a tendency to lump tax increases in the same boat with price increases, just as interest rate increases are also often spoken of as abetting inflation. Such views lose sight of the fact that higher taxes and interest rates are designed to dampen spending, thus bringing overall demand more in line with available supplies of goods and services.

I cannot leave the subject of fiscal policy without pointing to the severe handicap which failings in this area placed on the proper functioning of monetary policy. It has been the policy of the Federal Reserve to seek to preserve an "even keel"—that is, to avoid any significant change in policy or money market conditions—while Treasury financing operations are in progress. The constraints imposed by maintaining an "even keel", however, vary rather widely depending on the size and difficulty of the financing, with maturity a major consideration. Treasury tax bill offerings, for example, usually call for only minimal attention, whereas a large refunding may be very touchy indeed.

But "even keel", inhibiting though it may be with respect to timing of monetary policy actions, is a good deal less of a handicap to effective monetary policy than is the simple fact of a huge Federal deficit that must be financed. As an arm of Government, the Federal Reserve has an obligation to avoid acting in a way that could cause the failure of a Treasury issue, although that does not mean that the central bank should, or does, assure the success of particular offerings. The essential point is that the Treasury, like any other borrower, should meet the test of the market by offering terms that make its obligations attractive to investors. However, there is at least a temporary process in which the banking system must be provided with reserves while banks and dealers underwrite the offerings of the Treasury. The reserves may be with-

drawn later to exert pressure on the banks and dealers to distribute the issues to ultimate investors. However, if these offerings come in very large size and quick succession, a substantial bulge in bank credit may be well-nigh unavoidable. For example, in the second half of 1967, when much of the enormous $25 billion Federal deficit of fiscal 1968 had to be financed, the Treasury was almost constantly in the market, and the very rapid increase in bank credit and the money supply was partly a reflection of this fact.

As we survey the period since mid-1965, I think we must agree that monetary policy made its mistakes, though I would argue that these mistakes were a good deal less flagrant than those of fiscal policy; and, as I have just suggested, some of the failings of monetary policy were directly attributable to a very unsound fiscal environment. There were at least two occasions when, in retrospect, credit was eased too much—in late 1966 and early 1967, and in mid-1968. In both cases excessive fear of recession had much to do with the decisions made, showing that the Federal Reserve has shared to some extent the national predilection for exaggerating fears of recession as compared with those of inflation. The misjudgment in late 1966 and early 1967 was caused partly by an underestimate of the rising force of defense spending. Perhaps an extenuating factor in early 1967 was the unrealized hope that fiscal policy would make a significant contribution, and a related fear that monetary tightening might even jeopardize fiscal action. That of mid-1968 was caused by an overestimate of the dampening influence of a large Federal tax increase (and accompanying restraints on Federal spending). Contrary to expectations, consumers decided to sustain their spending in the face of higher taxes by cutting the proportion of disposable income saved. As a result, total spending and total economic activity continued to rise much faster than expected. The easing of monetary policy in mid-1968 followed six months of rather significant credit tightening. Initially the easing took the form of "accommodating the decline in market interest rates" that developed just before and during the enactment of the Federal tax and spending package. This euphemism seemed to place the Federal Reserve in a somewhat more passive and less aggressive role than if we had made an affirmative decision to ease because of fears that continued restraint plus the fiscal package would constitute too restrictive a program for the economic circumstances. But, semantics aside, the consequences were much the same as a decisive move toward ease. Money and credit grew in the last half of 1968 at a disturbingly fast pace.

Both periods of excessive easing that I have described were followed by several months during which the System might have reversed these tendencies in the light of continuing economic strength and continuing evidence of inflation. In the fall of 1967 there were in fact a number of occasions when we would have liked to move back to greater restraint but were inhibited by several powerful factors, one of which was the Treasury financing requirements I have already discussed. Another inhibiting factor was recurrent—and probably justified—fears that tightening moves in the United States might be all that was needed to force sterling into a devaluation, a development for which the American monetary authorities would certainly not like to have been responsible. Also, financial markets were becoming increasingly skittish as the second half of 1967 produced growing evidence of strong inflationary forces in the economy, and there were times when we were genuinely fearful that a tightening move might come close to causing panicky market conditions. Finally, with the Administration at last pushing the case actively for much needed fiscal restraint—a case the monetary authorities fully supported—there was naturally some reluctance to step on the monetary brakes and thus indicate skepticism of the ability of the Congress to take timely, responsible fiscal action. Possibly we were influenced too much by all these inhibitions, but I can assure you that they loomed large at the time.

The second period when we might have tightened and failed to do so was in the autumn of 1968. This time we were free of the problem of helping the Treasury to finance an enormous deficit, and we were also free from major worries over sterling. Even concern for market conditions was not a real inhibiting influence, although interest rates were rising to new peaks. But the Federal Reserve itself was deeply split by disagreements on the business outlook, with the majority still fearful of too restrictive a stance while others were convinced that we had no alternative to tightening in view of the clear signs of unchecked and, in fact, growing inflationary pressures and expectations. This latter school of thought finally prevailed in December 1968, but not before an excessively easy policy had produced far too high growth in the major credit and money aggregates.

The monetarist school has seized on these events, which with the benefit of hindsight must be marked down as errors in Federal Reserve judgment, to argue that we would have done much better simply to have permitted a gradual and rather steady growth in the money supply, with a minimum of discretionary policy. I disagree strongly with the suggested remedy. In the summer of 1967, for example, it would have been both unwise and impracticable to ignore the fact of a huge Treasury financing

need and to strive to hold the growth of the money supply to some predetermined low rate. The result could well have been an extremely sharp run-up in interest rates, perhaps accompanied by complete disruption of financial markets. Any disruption of financial markets would, of course, seriously interfere with the flow of credit that is essential to a satisfactory performance of the economy.

Let me add a few more general comments on the monetarist approach. If one assumes a mechanical relationship between changes in the money supply and subsequent changes in gross national product, it is not hard to conclude that the only sound monetary policy is to permit the money supply to increase at some moderate steady rate, for then the economy will grow commensurately, and who could oppose such a happy outcome? But I find grave flaws in this line of argument. In the first place, the velocity of money can change sharply and unpredictably over both long and short periods, at times reinforcing but at others completely offsetting changes in the quantity of money. We are indebted to one of my associates, George Garvy, for an up-to-date review of the role of velocity published last fall under the title "The Velocity of Money". It shows, among other things, that since World War II a larger part of the requirements of our growing economy has been accommodated by increases in velocity rather than by increases in the money supply.

But an even more glaring weakness of the whole monetarist approach is the failure to spell out the process whereby money-supply changes bring about the alleged resulting changes in the economy. This whole area is usually dismissed as too complex to try any analysis of it; hence the reliance on a simple formula that has been "proved" by recorded past events. However, a close study of the alleged proof shows that it is far from conclusive and indeed seems questionable in a number of respects. Let me make clear that the Federal Reserve System does pay, and always has (at least in the postwar years) paid, a great deal of attention to the money supply. We also pay a great deal of attention to changes in total bank credit and other credit and to changes in interest rates, since all these factors can, and do on occasion, exercise a strong influence on changes in the total economy.

It is illusory to think that the application of monetary policy can be reduced to a simple formula focusing on some one measure. To attempt to achieve a steady growth rate for the money supply over any short period would be impracticable, in the light of big random swings in the various elements having an impact on bank reserve positions, and undesirable, as it would cause wild gyrations in other monetary factors capable of affecting economic decisions. And, on the basis of post-World War II experience, I simply cannot believe that changes in fiscal policy and in the Treasury's financing requirements can be disregarded while the Federal Reserve pursues a course of expanding the money supply at a fixed rate. In my view, effective central banking will always involve a good deal of human judgment in weighing the importance of all these and other factors in the particular circumstances prevailing at the time when policy is being determined. Undoubtedly our understanding of causation in economic processes will improve over the years, but it will, I think, be a long time before the application of monetary policy can be termed anything like a precise science.

Balance-of-payments considerations did not conflict with domestic monetary policy requirements during the years under review. This was in strong contrast to the situation in the early sixties, when we went through all sorts of contortions to find ways of stimulating the domestic economy without doing undue damage to our balance of payments. Since our payments deficit continued to be a major problem in the second half of the decade, but with inflation our greatest difficulty on the domestic front, it is obvious that the restrictive measures we were able to take were useful from both a domestic and a balance-of-payments point of view.

Since the record of fiscal and monetary policy in checking inflation after mid-1965 has been so unsuccessful, it is perhaps surprising that other means of fighting wage and price increases were not resorted to more vigorously. Direct efforts, through moral suasion, to influence wages and prices might be expected to bring at least some marginal benefits at a time when the more basic policies are laggard. It seems to me that the so-called "guideposts" in the early sixties had considerable educational value in focusing attention on the truism that wage settlements consistently higher than national productivity gains are bound to lead to lower profits or higher prices or both. When the line was broken in 1966 by an excessive settlement in the airlines industry, the Government seemed to lose interest in the guideposts and to assume that any further approach of this kind was futile. Then, with the accession of the new Administration in 1969, there was an apparent determination to rely wholly on fiscal and monetary policies and to steer clear of anything smacking of moral suasion with respect to prices or wages. To my mind this was a case of letting a "hands-off" philosophy get the better of a practical need. I believe that some kind of Government interest in this area, publicly expressed, can play a useful role.

Certainly both wages and prices soared in 1969, with the increases reaching the point where more and more

individuals began to question not only the absence of moral suasion but even the absence of compulsory wage and price controls. In the minds of businessmen, of course, compulsory controls usually mean controls on wages whereas they probably have little thought of accompanying price or profit controls. It should be stressed that rigid controls are likely to prove quite illusory and, at best, of only temporary value.

As we enter 1970, the importance of checking inflation can hardly be exaggerated, whether we think in purely domestic terms or in terms of our balance of payments and the future of the dollar as the key international currency. I have purposely focused today on domestic matters, but I think it fairly obvious that a braking of inflation, by restoring a reasonable trade surplus, provides the greatest hope of a better United States balance-of-payments position.

What are the prospects for an effective domestic stabilization program, in the light of the lessons and disappointments of the past four or five years? To form some estimate, it is useful to give attention to what has been going on in the past year, what momentums have developed, and what changes seem fairly clear in the making. First of all, it is necessary to pay tribute to a vastly improved fiscal situation, at least through 1969, as compared with, say, the huge deficit of fiscal 1968. And it is also appropriate to recognize the consistently strong backing which a firm Federal Reserve policy has received from the Administration.

But there are important qualifications on the fiscal side. The maximum restraining influence of a sounder budget policy has already been felt. The budget is now moving in the other direction, both because of sizable prospective expenditure increases—including enlarged social security outlays, higher Federal pay rates, etc.—and because of recent and prospective tax cuts. I personally think it was unwise to reduce the 10 percent surcharge until success on the anti-inflation front was at least faintly visible. In any case the Federal budget will become increasingly stimulative over the coming months, in the absence of new initiatives designed to check this trend. Secondly, a part of the budget improvement in 1969 was illusory, achieved by taking out of the budget several major Federally sponsored spending programs that were still important economic stimulants and important sources of credit demand. Another possible criticism has to do with the official public stress on gradualism and on the avoidance of recession, which helped to create the kind of belief in a perpetual boom—or a perpetual boom attenuated by only minor interruptions—that has played so big a part in strengthening widespread inflationary expectations and businessmen's capital spending plans.

It seems to me that we face a crucial test of economic policy over the coming months. Will the traditional use of monetary and fiscal policy succeed in checking the course of inflation, or will we as a nation be driven to experiment with more direct controls—a line of experiment which I very much hope we can avoid? Obviously the process by which monetary and fiscal policy can check this long and deeply seated inflation involves a substantial slowing of economic growth, perhaps over a fairly extended period. I realize, of course, that a period of relatively slow economic growth will involve some hardships, such as employment opportunities lost and income foregone. However, I strongly believe that it is better to face up to these hardships now, mitigating them with special programs to help those who are particularly hurt, than to relax our stabilization efforts prematurely, thereby making necessary a much more difficult readjustment in the future. The longer we allow inflation to run unchecked the more painful and costly will it be to bring it under control again.

The slowing of the economy has already commenced; in the fourth quarter, real gross national product was unchanged. But it is by no means clear that the slowing will be lasting enough to prove effective. Inflationary expectations have been built into the economy so strongly over the past four or five years that they cannot be changed easily. I find it hard, given these conditions, to understand the point of view of those who for some time have been clamoring for an easing of policy in order not to run the risk of recession. There is necessarily some risk of recession in the kind of policy we have been applying. If there were not, it would be wholly ineffective. But the opposite evil, inflation, is not merely a risk; it is and has been an actuality. Thus, if we weigh the conflicting risks, we find very strong reasons to hold the line. Of course there are some economists who argue that a serious recession is already assured by reason of the weak performance of the money supply over the past six months. I hope I have already made clear that I see no merit in any such mechanical view. The biggest dangers I see on the horizon are (1) the danger that fiscal policy will be a weaker and weaker ally of monetary policy in the anti-inflation effort and (2) the danger that pressures from outside the Federal Reserve and inside the System itself will prevent our maintaining a sufficiently restrictive policy for a long enough time to turn the trick. Skepticism on this point is unfortunately widespread.

In this connection, provided a suitable combination of monetary and fiscal policy can be put in place, there is much to be said for greater use of Government persua-

sion to induce those who are in a position to determine wage and price levels to exercise great restraint in making these decisions. With inflationary expectations as deeply embedded as they are, this effort might be a helpful, and reasonably costless, supplement to monetary and fiscal policy in achieving acceptable price-cost stability without an excessive slowdown. It might persuade people here and abroad that the Government intends to use all its powers to brake inflation.

I am well aware that maintenance of a firm monetary stance, especially in the event of weakening fiscal support, will tend to keep markets in their highly uncertain state and may continue to cause serious problems for some financial institutions. But special facilities are available to assist the latter, and the Federal Reserve is always in a position to relieve market pressures if the need becomes acute. On the whole it has been reassuring that our financial institutions have been able to remain as viable as they have in the face of the unprecedented interest rate levels we have witnessed in the last few years.

It would not be right, in speaking to bankers, to omit mention of one area where the banks have become increasingly critical of the Federal Reserve. I am speaking, of course, of the use of deposit interest rate ceilings as an instrument of credit control, with all the complex ramifications that are so familiar to you. Let me just say that I believe the System has gone too far in this direction, although it should be recognized that all this time the Congress was exerting great pressure to go even further along this road. There was some obvious attraction in using Regulation Q to put pressure on the banks and thereby to hold down credit growth. It could also be argued that the use of Regulation Q put special pressure on large banks and that this would make credit harder to come by for big corporate borrowers; but this reckoned without the ability of large corporations to bypass the banking system and obtain funds directly in the open market. Moreover, the Q effort did not take sufficient account of the ability of the banks to devise various escape routes and of the increasingly complex regulations designed to close these loopholes.

Large-scale exploitation of one major alternative source of funds, the Euro-dollar market, tended to intensify the effects of our tight money on foreign nations. This use of Euro-dollars had some immediate balance-of-payments advantages, but it also set the stage for what might become a difficult payments situation if American credit conditions become considerably easier than they are today. For all these reasons I believe that it is none too soon for the System to be thinking hard of ways to soft-pedal this use of rate ceilings as a policy instrument, while still maintaining a firm general policy stance through an appropriate combination of the more traditional instruments of monetary policy. I therefore welcome last week's move to modify some of these ceilings.

I am not pessimistic about the outcome of the anti-inflation campaign. Already there are a few encouraging signs. What we need, as has been true right along, is the conviction of Americans in all walks of life that inflation is a major evil that must be mastered, and the willingness to forego immediate maximum personal gain to help achieve this goal. When a labor union obtains an outrageously high settlement, or when an employing organization blithely accepts such a settlement with the firm intention of passing on the higher cost in the form of higher prices, they are jeopardizing the effectiveness of a fiscal-monetary approach and inviting some drastic, highly undesirable, and probably ineffective, direct Government control. I am hopeful that a spirit of reasonableness will prevail before it is too late. As usual, you bankers are inevitably in the forefront of the effort. I have no doubt that you will use all your powers of persuasion to help assure effective cooperation in this highly worthwhile effort by business, by labor, by Government, and indeed by all our countrymen.