Statement by Alfred Hayes To the House Banking and Currency Committee

Editor's Note: *This statement on current economic problems as they relate to monetary policy and the Federal Reserve System was presented in testimony to the Committee on Banking and Currency of the House of Representatives on July 17, 1974 by Alfred Hayes, President of the Federal Reserve Bank of New York.*

Mr. Chairman and members of the Committee, I am happy to have this opportunity to express my views on some of our current economic problems, especially as they relate to monetary policy and the Federal Reserve System.

I would like at the outset to add my voice to those who believe that our most serious current economic problem is inflation. Indeed, the solution to many of our other difficulties, including high interest rates, the slump in housing, the liquidity problems of business and financial institutions, as well as many of our problems in the international financial sphere, depends importantly on our ability to get inflation under control. I believe that control of inflation clearly should be the main objective of monetary policy for the present and probably for quite some time to come.

Our current inflationary situation has had a long evolution, dating back to the mid-1960's. It began with our unwillingness, for a long period, to provide increased taxes to finance the Vietnam war and expanded social programs. The result was an excessively stimulative fiscal policy and pressures on aggregate demand. The ensuing demand inflation led, in due course, to cost pressures and to steadily mounting inflationary expectations. These secondary, but apparently inevitable, consequences of prolonged demand pressures made inflation progressively more deep-rooted and difficult to cure. The recession of 1970 removed demand pressures for a time. While it went too far in generating idle resources, the rate of inflation did begin to come down. Unfortunately, the gains in this respect were disappointingly slow and modest to an understandably frustrated public. I believe the program of price and wage controls begun in mid-1971 made a significant contribution to reducing inflation as long as demand pressures remained under control. By late 1972, however, the economy was again expanding too rapidly. Demand pressures reasserted themselves, making controls of little use and even counterproductive over the last portion of their life.

Over a long period of nearly ten years, we have paid an increasingly heavy price, in terms of irregularly accelerating inflation, for giving insufficient attention to the limits on our capacity to meet ever-growing demands at stable prices. Over most of this period the Federal budget has been in significant deficit, and fiscal policies have certainly been too expansionary during the period as a whole. Nor would I argue that monetary policy has been immune over this long period to the national tendency to try to expand demand at a rate in excess of what can be produced at stable prices. Indeed, I think there have clearly been times, particularly in 1968 and in 1972, when monetary policy has been rather too expansionary.

In any case, I think we have learned that the virus of inflation becomes progessively more difficult to cure as its treatment is postponed or neglected. The prospect of an ever-accelerating inflation is truly frightening in its implications for the stability of our economic and social system. The point has now been reached where we must direct our attention to solving this problem even though the cure may have painful side effects in the short run. As I will later indicate in more detail, I do not believe that our present inflationary problems stem solely from demand conditions. Nor do I necessarily believe that monetary and fiscal policies, our main tools of demand management, are the only ones we should use in bringing

inflation under control. Nevertheless, I think it is clear that prudent moderation in aggregrate demand is an absolute precondition to the restoration of price stability. And monetary policy certainly has a very large role to play in this development.

Against this general background, I would like to address myself now to some issues in which the Chairman indicated a particular interest in his letter inviting me to testify. One of these issues is the so-called "trade-off" between inflation and unemployment and its implications for formulating monetary policy. In my view, the notion that unemployment can be permanently reduced below some specified minimum simply by pumping up aggregate demand—and without any improvement in the structural characteristics of our labor markets—is quite misleading. Indeed, the notion that low levels of unemployment can be achieved by monetary policy alone—provided only that a little more inflation be tolerated—has probably caused a good deal of mischief.

To be sure, if unemployment is abnormally high, the judicious application of monetary stimulus can help reduce unemployment to more moderate levels with little adverse effects on inflation. Beyond a certain point, however, one that seems to be dictated largely by the structural characteristics of labor markets, attempts to reduce unemployment in this way require progressively larger doses of stimulus. The resulting inflation which may be moderate at first, tends to accelerate progressively. In time, inflation comes to be built into the structure of costs and expectations and its stimulative effects wear out. Thus, a progressively more rapid inflation is required to achieve given effects on unemployment. Certainly, our present situation of unemployment in excess of 5 percent, coupled with the escalation of inflation rates that we have witnessed, strongly suggests that this process has been at work over the past decade.

I do not pretend to know just what rate of unemployment might be a sustainable minimum for price stability under the conditions of the 1970's. I do feel sure, however, that it is something materially above the 4 percent figure that was often cited in the past as an appropriate full employment goal.

At the same time, I do not want to suggest that an unemployment rate such as 5 percent need be accepted for all time as the best we can do under conditions of sustained price stability. What I think has to be recognized is that the only way permanently to reduce the levels of unemployment compatible with price stability lies in measures that will increase the qualifications of the labor force that are in demand and that will produce a more efficient and speedy matching of willing workers and available jobs. Attempts to solve the problem by pumping up aggregate demand can, in the end, have only devastating inflationary consequences with the accompanying risk of leading ultimately to really serious slumps in the economy and in employment.

Even if we could be sure we could trade a higher level of employment for an additional measure of inflation, this would seem to be a very bad bargain for the American people under the present circumstances. The longer inflation is allowed to run unchecked, the larger will be the distortions built into the economy and the more difficult and painful will it be to bring inflation under control. Thus, even though unemployment is not as low at present as most of us would like to see it, I think we have no real alternative to a policy of moderate but continuing monetary restraint. The short-term costs of restraint at this juncture will be less than would ultimately have to be paid if we were to allow inflation to gain even further headway before acting decisively to bring it under control.

A somewhat special problem for monetary policy in combatting inflation can arise, as the Chairman suggested in his letter, when nonrecurring price increases stemming from supply shortfalls arise. The increase in petroleum prices associated with the Middle Eastern oil boycott last winter is the most conspicuous recent example. I think it is difficult to generalize about the possible implications for monetary policy of such developments. Much depends upon circumstances.

In some cases, I would think such developments need not require any change in the thrust of monetary policy. In principle, the rise in prices in one sector of the economy may set in motion compensating price changes in other sectors as available funds are diverted to the sectors where prices have risen. Thus there may be, especially in the longer run, little net change in inflationary pressures, and no reason to change the thrust of policy. In particular instances, however, much depends upon the flexible and timely reaction of prices in the sectors not directly affected by the special development. In the shorter run, such developments clearly can add to the overall rate of inflation.

Of course, shortages of oil or other essential commodities can have a magnified depressing effect on total real output since they are needed to produce other goods and services. This was a matter of considerable concern during the recent oil embargo. While we in the Federal Reserve were under no illusions that we could increase the supply of oil by increasing the supply of money, we were also alert to the danger that the shortage-induced downturn in the economy could cumulate into a general recession. We were prepared to ease monetary policy if such a

process seemed to be getting under way. This did not develop, however, and policy was not changed in any major way in response to the effects of the embargo.

I would now like to turn to the relationship between monetary and fiscal policies and the problems posed for monetary policy by fiscal stimulus in an inflationary environment. Monetary and fiscal policies are most effective when they are used in tandem, rather than working at cross purposes. While monetary policy can offset some of the effects of an excessively expansive Federal budget, it cannot compensate for all of the shortcomings of fiscal policy. Our experience over the past several years bears testimony to this truth. While a combination of factors has exacerbated our inflationary problem, Federal budgetary deficits have played a significant underlying role.

When productive facilities are strained by excessive demands for goods and services, Federal deficits tend to exert upward pressure on prices, as the Government competes with the private sector for scarce resources. At the same time, deficit financing also puts upward pressure on interest rates as the Government bids for credit to cover its deficits. This situation creates a dilemma for monetary policy. To underwrite the deficit by monetizing the Federal debt would, of course, tend to be inflationary. And inflation tends in the longer run to become imbedded in the credit markets in the form of higher interest rates, as I shall indicate more fully in a moment. On the other hand, preventing credit from expanding to accommodate a Federal deficit would tend to put immediate upward market pressures on interest rates. Such developments are, of course, unpopular and it is all too easy, almost without realizing it, to accommodate the pressures generated by fiscal deficits.

Reliance on monetary policy alone to restrain inflation in the face of overly expansive fiscal policy therefore does entail risks. Rising market rates of interest induce savers to withdraw funds from thrift institutions, thereby drying up the major source of private financing of residential construction. Extremely tight money, moreover, can imperil the liquidity and even the solvency of credit-dependent firms. The Federal Reserve cannot be oblivious to the risks of pushing monetary restraint too far. We must bear in mind our essential role as lender of last resort to the economy. If liquidity pressures mounted to the point that a breakdown of the credit system appeared to be a serious threat, the Federal Reserve would have to take steps to forestall it. This might entail some temporary deviation from the monetary growth rates that would be consistent with long-run price stability.

In practice, monetary policy must weigh the dangers of accommodation against those of resistance to excessive fiscal stimulus. The results are unlikely to be entirely satisfactory as long as excessively expansive fiscal policy is tolerated. I am encouraged by Congressional steps to gain better control over fiscal policy. I hope a more active and concerted role by the Congress in framing fiscal policy will significantly diminish the risk that monetary policy will have to select among bad choices in the face of inappropriate fiscal policy.

In commenting on the role of fiscal policy, I do not want to imply that monetary policy has not played a role in the evolution of our present situation. Indeed, as I indicated earlier, I think monetary policy has clearly been somewhat too expansionist at times over the past decade.

I would now like to turn to the relationship among the monetary aggregates, inflation, and interest rates. Certainly, there has been, historically, a broad long-run relationship between trends in monetary expansion and the behavior of prices. Over long periods of time, price stability depends upon a rate of money and credit growth commensurate with the economy's capacity to produce. Ultimately, therefore, the return to an era of price stability will require the restoration of the monetary aggregates to moderate rates of growth. And I should perhaps add that some of our current notions of what constitutes "moderate" growth would have seemed rather rapid in an earlier period of relative price stability.

It would, however, be a gross oversimplification to attribute all fluctuations in the pattern of inflation to the behavior of the monetary aggregates. There may be many nonmonetary developments that can have powerful influences on the behavior of prices for periods as long as one, two, or more years. The special case of supply shortages, as in the recent fuel and food cases, has already been touched on. As I noted earlier, such supply developments need influence only relative prices in the longer run, with spending being diverted from other sectors whose prices should in principle fall, or at least rise less rapidly, leaving the overall rate of inflation unaffected. But in the shorter run, the prices of goods in sectors not directly affected by such special developments may be rather unresponsive to demand conditions. Under these circumstances, there may be, and I believe have been, significant, if temporary, effects on the overall price level.

There are, moreover, many other factors that may have an important influence over prices quite independent of the behavior of the monetary aggregates. One of the most conspicuous of these in recent years has been behavior of foreign exchange rates. I think there is little question that the overall depreciation of the dollar since early 1971 has been a significant inflationary force in this country. The depreciation of the dollar has raised the

dollar prices of goods we import. It has also tended to raise the prices of goods produced in the United States and sold in both domestic and foreign markets.

Among other influences on inflation apart from the behavior of the monetary aggregates, I have already noted the role of excessively stimulative fiscal policy. More broadly, I think the rough long-run statistical parallelism between price and monetary behavior conceals important social and political factors that partly account for this statistical relationship. The well-known association between wars and inflation, for example, has often reflected the unwillingness of governments to finance military spending through adequate taxation. This has often led to pressures on central banks to accommodate government borrowing through excessive monetary and credit expansion. And wars have not provided the only instances of governmental failure to face up to the costs of spending programs with consequent pressures, direct or indirect, on central banks to make up the difference by monetary expansion.

With regard to the relationship between inflation and interest rates, the trend to high levels of interest rates that has developed over the past several years has clearly reflected in major part the behavior of prices. In a situation where rising prices have steadily eroded the real value over time of debt instruments, lenders have come to demand an inflationary rate premium, and borrowers have felt justified in providing it. It is hard to persuade savers to lend their savings at interest rates lower than the rate of inflation, especially when real estate and other commodity investments exist as alternatives to fixed dollar instruments. In this setting, an attempt to bring down interest rates by rapid expansion in money and credit would be self-defeating, except perhaps in the short run. I am convinced that the only way to restore more normal levels of interest rates is to restore price stability—and this will require restraint in monetary expansion, not extravagance.

The problem for monetary policy in bringing inflation under control and interest rates down to more normal levels is indeed essentially a single problem. The solution requires a degree of monetary restraint over a period sufficiently long to wring inflation out of the economy. This will mean gradually reducing the growth of the monetary aggregates to a trend compatible with long-run price stability.

The task of restoring price stability is likely to be protracted. The experience of recent years indicates that our price system reacts only gradually to changes in demand conditions, owing to the long-lasting secondary effects of demand pressures on costs and expectations. In view of these factors, I do not expect price behavior to react quickly to monetary restraint. The length of time that will be required to bring the long-run trend of monetary expansion, aggregate demand, and price behavior to a satisfactory point will depend upon a number of factors. The ability of our financial markets to withstand restraint and the impact of restraint on unemployment and on particularly sensitive areas of the economy, such as the savings institutions and the housing industry, will affect the feasible path of monetary policy.

On a number of occasions in recent years during periods of monetary restraint, tight money conditions have resulted in sharp liquidity pressures on particular institutions or particular segments of the markets. In some instances these have been so acute, or threatened to become so acute, as to create risks for the financial system as a whole. In such instances, the Federal Reserve has recognized and accepted its responsibilities, particularly in its role as lender of last resort, and has taken action designed to cushion the impact of such pressures.

There are a number of things that might be done to make the task of monetary policy easier. Fiscal restraint is certainly one of these. A budget surplus would be very helpful in relieving strains on financial markets. Programs to aid housing, such as those recently announced by the Administration, are another example. A third would be efforts to improve the functioning of our labor markets, perhaps including, if needed, Federal job programs for the unemployed.

An important factor that I hope will make our job easier this time is the widespread conviction on the part of the American public that inflation is public enemy number one. I am hopeful that this will be reflected in a healthy measure of self-restraint by all of us in our common fight against inflation—including restraint by labor in wage settlements and by industry in the setting of prices.

In any case, I think a path of prudent monetary restraint for however long is needed to restore price stability is the only responsible course of action. A premature easing would lead to a resurgence of demand pressures and a renewed and even more virulent acceleration of inflation. This would, I am convinced, pose serious dangers for our economic and social fabric. Price stability is the key to many things, to low interest rates, to a smoothly functioning financial system, to a healthy housing industry, to a strengthened international economy, and to the opportunity for sustainable economic growth. All of these things can be achieved through responsible policies, including monetary policy—not without temporary costs, to be sure, but at costs that will be far outweighed by the benefits accrued.