The Dilemmas of Monetary Policy

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Fellow New Yorkers:

I am emboldened to use that simple salutation tonight for more than one reason.

At the most personal level, I was reminded the other day where my own roots lay. I heard a tape recording of some remarks I had made. After spending three quarters of the past sixteen years in Washington, I confess to being startled by what I heard—the full, rounded tones of a homegrown New York accent.

Perhaps it is just that I am a bit more conscious of that fact today than I would have been in other circumstances. I have returned to this great city just in time to see it struggling with its greatest challenge. That challenge comes packaged in financial wrappings. But there can no longer be any doubt that, underneath the wrappings, there are issues that run deep into the economic and social fabric of the city and its relationships to the state, the nation, and even the world.

My intent tonight is not to dwell at length on the problems of the city. After all we have read and heard, to try to describe the current situation would risk tedium and being dated by tomorrow's papers at the same time—no mean trick. What I hope we have learned is that financial acrobatics cannot ultimately substitute for hard, definitive decisions and actions on the substance of the problem. That illusion has brought us to the edge of an abyss, the nature of which none of us can clearly foresee.

What does strike me, as I have observed the debate on New York, is that we are seeing here in sharpened and exaggerated form, issues closely relevant to the broader debate on national monetary and economic policy.

It would be easy to generalize too far. Our local problems have been aggravated by the particular pressures endemic to older urban centers. They have been thrown into sharp focus by the special history and traditions of this proud place, seeking to maintain itself in the forefront of social progress, even while its enormous commercial advantages and base of wealth have, in relative terms, been eroded. After allowing for all those special circumstances, the competing cries that we hear for "more financing", on the one hand, and for "more adjustment" in services and in budgets, on the other, seem to me to parallel some larger dilemmas in national policy. In the country as in the city, there are, in my judgment, no purely financial solutions to those dilemmas.

Quite obviously, economic performance in recent years —not just in the United States, but in other countries as well—has fallen far short of the standards we set for ourselves. We have seen at the same time in this country, the highest levels of unemployment and the highest levels of inflation of the postwar period. While the seventies have seen boom as well as recession, real growth has slowed to 2 percent in the past five years as a whole, and productivity growth has sagged. Real take-home pay of the average man and woman at work and real profits have both declined over the past two years, a most unusual combination of circumstances.

I have not described a pretty picture.

Measured against the exuberant hopes of a decade ago, it seems even more disquieting.

The mid-1960's, you will recall, seemed the golden age of economics. Leading practitioners—particularly as they left government service—could lecture with apparent justice about how we had destroyed the old mythology and had finally learned to apply the lessons of modern economics to practical policy. Growth would be assured; we

could extend all those trend lines showing a rise of about 4 percent a year in the real gross national product almost indefinitely. Deviations around the trend would be contained. We could calculate, if we wished, a "trade-off" of a little more inflation for a little more employment, or vice versa, depending on our social preferences.

It was almost as if, after proving we could go to the moon, we could somehow run the economy at the console of a computer as well. The new challenges were said to be income distribution and social justice—not macroeconomic policy.

Well, it did not take long to shatter those visions. Today, we make more forecasts; we wrap them up in more mathematics; we use more complicated "models"; and we use up much more computer time. Yet somehow we have much less confidence in the results. In frustration, we are tempted to ask if the textbooks have relevance and whether our economic theories are in need of wholesale revamping.

Why have events diverged so much from the expectation?

One approach to the answer seems clear enough. We have permitted ourselves to get caught up in an inflationary process.

Some of the ways inflation has impaired our economic performance and prospects, particularly by distortions in financial markets, can be measured more or less directly. As prices have risen, businesses and financial institutions have found their balance-sheet totals expanding at a rapid pace. In the process, liquidity was impaired as lenders shied away from longer term commitments. Even more strikingly, the base of equity capital has not kept up. Strong wage and cost pressures—particularly when they collided with a weakening in real demand—squeezed profits and profit margins, making it harder to raise equity and to justify new investment at inflated prices. As inflation became imbedded in market thinking, long-term interest rates became "sticky" at historically high levels, even when the supply of financial capital improved during recession.

Less measurable, but perhaps more insidious, a pervasive air of uncertainty came to surround longer term commitments. As consumers and businessmen began to feel that their economic well-being and the results of their investment decisions were as dependent upon the trend of prices as upon their own productivity and business judgment, we began to see reactions that seem perverse by accepted axioms of economic behavior. Policymakers have been faced with the possibility that monetary and fiscal actions intended to stimulate may be interpreted as aggravating inflation. The result may be to push up interest rates or encourage precautionary savings, undercutting the purpose of the actions.

A central banker citing the evils of inflation hardly provides a fresh perspective, nor does deploring inflation seem to me to provide an adequate answer to the question I have posed. We have to push the matter further. We have to ask ourselves why the inflation arose in the form that it did, and whether the distortions in financial markets are not symptomatic of some broader currents in our economic life.

When I was in college, some older economists were still fond of talking about a "long cycle" in economic affairs with protracted periods of buoyancy and exuberance eventually giving way to periods of uncertainty, slow growth, and outright contraction. When these long cycles were mechanically related to such esoterica as the appearance of sun spots, debunking was easy. But I wonder if there is not more than a germ of truth, in terms of human behavior, in some of their observations.

It took a long time after World War II to convince ourselves that prosperity was really here, that a relapse into a great depression was not a significant probability. By the mid-1960's, confidence had replaced these doubts —and, as it did, the very serenity we felt about our economic future led us into patterns of behavior that have now turned out to be unsustainable. None of us individually would want to plead guilty. But we have to ask ourselves whether, collectively, we did not permit the general feeling of economic security and even euphoria to divert us from norms of prudent conduct—from a sense of limitation and restraint on risk taking—essential to ordered growth and stability.

In raising this question of attitude and psychology, I do not want to ignore some obvious concrete facts of the history of this period. Our failure to face up to the financing of the Vietnam war in a timely way—against the preponderance of economic advice—has often been rightly cited as one key factor in setting off the subsequent inflation. Much more recently, we have had the shock of increased energy prices. But even in those decisions, where political considerations plainly intruded heavily on economic judgment, the latter may have been weighed too lightly, partly just because there has been a sense that the future was assured and that we had the tools and the knowledge to repair any temporary damage.

With the benefit of hindsight, the evidence of overreaching—of putting aside traditional cautions and taking new risks—is now clear in the financial markets themselves. For instance, as the cult of performance took hold, active trading of securities replaced a sense of long-term investment commitment. We lost sight of the fact that

"performance" was always dependent on access to highly liquid markets and on being among the first in and the first out. The glow of success could last only as long as most, in fact, did not want out. As the game broke down, the actual result was more instability and less perceived liquidity in many investment markets. Those facing the need to raise new capital found their task greatly complicated.

Even when market conditions were highly favorable, however, many business managers seemed to attach less importance to raising equity capital. Whether in financial institutions or elsewhere, they began to rationalize departures from old standards of capital adequacy and liquidity. In a world where "downside risk" seemed diminished, the attractions of high leverage were natural. We began to hear the theory that the only thing that mattered is that you were no worse off than your competitors; after all, in the last analysis, the government would need to step in to prevent catastrophe anyway.

In such a climate, regulatory restraints chafed even harder. With considerable justification, there was concerted effort to eliminate outmoded, archaic, and anticompetitive rules and regulations. In the banking world, in particular, relaxation of interest rate ceilings and the vogue for liability management seemed to open new vistas for expansion without clear limitation. Freed from old restraints, loan officers could move more aggressively at home and abroad, and their activity often seemed to support the objectives of national policy as well. But it is possible to question whether the enthusiasm for eliminating the old and outmoded was matched, by the regulated or by the regulators, with recognition of the need to retain or shape safeguards suited to today's conditions.

Similar psychological processes were at work elsewhere. In a world in which workers are told an average rise in real income of about 3 percent a year is virtually assured, few will be satisfied to remain below the average and many will find easy justification to exceed it. We seized opportunities to take giant steps forward on behalf of the old, the infirm, and the unemployed. Altogether, the new demands exceeded the capacity of the economy. We were hardly prepared for a situation in which external forces, whether because of poor crops or an oligopoly-imposed increase in oil prices, inexorably squeezed the living standards of most workers.

To return to home, some of this same psychology must have accounted for the willingness of the city and its citizens to seek ever higher levels of services, despite a weakening economic base, without the alarm bells ringing at a much earlier time. Against a background of prolonged prosperity and high priority for social objectives, what could be more natural than to make full use of welcoming bond markets? If such resort involved some abrogation of irritating budgetary and financing conventions, could this not be accepted in an era of "creative" and "innovative" finance? In the long run, after all, growth and inflation would smooth over any difficulty.

I recognize the danger of abstract theorizing about human psychology. Nevertheless, in retrospect, attitudes developing over the past decade do help to explain some of the dislocations and difficulties today.

It was not so much a conscious willingness to take large new risks, but that the consciousness of risk was itself reduced. It was not so much that we saw ourselves acting without a sense of prudence, but that the definition of prudence was itself changed. It was not so much that we thought the laws of economics had been repealed, but that we could manipulate them to our will.

I recognize there is a school of thought that would lay the blame much more directly at the feet of monetary policy. According to this thesis, "inflation is always and everywhere a monetary phenomenon". There is no need to look further for culprits or to seek explanation in changes in economic structure or attitude.

Now I am not about to deny the correlation between growth in the money supply and the price level; over a long enough period of time, excessive growth in the money supply is bound to bring higher prices.

Taken alone, the monetary explanation seems to me seriously incomplete. For one thing, the correlation between money and prices is far from perfect. There is no way that even the relatively rapid monetary expansion of 1972 and 1973—averaging 7½ percent—can by itself explain double-digit increases in consumer prices and the much stronger surge in wholesale prices last year. Clearly, nonmonetary factors can have an important impact on inflation—and an impact that is "temporary" only from a more Olympian time perspective than most of us can afford to assume.

Monetary policy does not work in a vacuum, political or economic. Inflation, once started, can become embedded in the fabric of expectations. Whether the initial impetus is monetary or nonmonetary, the expectations vastly complicate the job of bringing inflation under control.

It seems to me unrealistic to the point of being meaningless to say, for instance, that monetary policy can always press to whatever point may be required to bring price stability. We have to consider whether the result of that action would be consistently higher unemployment, prolonged inability to finance the investment needed to support a growing economy, or even dislocations in

our basic financial structure. If monetary policy has to bear the load alone, cutting across the grain of other deep-seated elements of economic behavior, those consequences cannot be ruled out.

To take the other side of the coin, neither can the monetary authorities reasonably accept whatever they find in the way of price expectations and other economic pressures and proceed within that context to provide the money and credit to finance ever higher levels of business activity. Such an approach can only reinforce inflation and require that we validate every excess in the behavior of large economic units. The result, it seems clear, might be to postpone the day of reckoning, but not to avoid it.

In important respects, the problem from a national perspective is not all that different from the problem of how best to deal with the situation facing New York. At one extreme, to ask for and to receive financing *without* real adjustments in the underlying economic and budgetary situation would merely pave the way to a larger crisis in the future. To expect adjustment so quick and draconian that new financing will not be required over a transition period may be equally shortsighted.

Faced with such dilemmas, there is a natural longing to look toward new avenues for easing the "adjustment problem". On a national scale, the list of proposals is a long one: (1) Removal of the evident and numerous obstacles to efficiency and productivity would obviously help; we all can make a list as long as our arm. (2) Improved competition in labor and product markets could reduce rigidities in costs. (3) We can and should review regulatory practices—not only those lingering from an earlier era, but those growing out of more recent environmental and consumer concerns—to see if they are achieving worthwhile objectives at acceptable cost. (4) I suspect we have too long neglected exploring techniques—some long established in other countries—that might improve the atmosphere at the bargaining table. For instance, as we look with admiration at the postwar German economic performance, can we dismiss entirely the ideas of "codetermination" and "concerted action" developed in that country as methods of achieving more understanding among business and labor? (5) Potentially most important in my view, those elements of our tax structure that serve as a drag on investment activity, and particularly penalize equity financing, need review and reform. But citing these five areas suggests their limitations for resolving our current dilemmas. However attractive in the abstract, in their specifics they will be fiercely debated. Whatever their future potential, they must be longer range measures.

In the here and now, the chances for improved performance in the nation and in the city seem to me to rest on changes in attitudes that have been nurtured over a long period of prosperity and stability. The harsh reality is that such changes seldom take place except under the pressure of events.

In our market system, these pressures for change—the signals for action—typically come in financial form. A business or a government exhausts its credit resources; individuals cannot spend beyond their income for very long; the unprofitable and undercapitalized firm eventually capsizes in an economic squall.

In theory, we could, of course, organize our economy differently, so that financial pressures did not play so prominent a role. Carried to one extreme, direct pressure and force can be applied by a government, as they are in a communist society. All of us would reject that.

Western governments, including our own, have more pragmatically experimented with "incomes policy"—guidelines or controls of varying degrees of severity over prices and wages. I am hardly in a position to be doctrinaire on that subject, having in 1971 advocated the freeze precisely to help change inflationary expectations. Whatever the merits of that experiment, I see no credibility in a renewed attempt now or in the foreseeable future in this country. Moreover, experience here and abroad in peacetime suggests strongly that milder controls cannot be effective for long when inconsistent with market pressures and when they too easily can be invoked as a substitute for other essential action.

So, it seems to me an illusion that we can find the path to renewed stability other than through the disciplines inherent in the market. We cannot expect the process to be smooth and steady. But we can be sure that it will be speeded and eased to the extent individuals, businesses, and governments recognize the need for changes in behavior and attitudes that rest on conditions that no longer exist. Our success will depend as well on the skill and wisdom we can marshal in shaping our monetary and fiscal policies.

The setting in some respects is propitious. We can shape our policies against the background of a rapid rebound in business activity. Despite some nasty surprises, the overall picture on inflation this year is at least better than last. Moreover, the improvements in productivity that should accompany expansion offer some prospect that the rise in labor costs per unit of output could moderate for a period, even as business improves.

Nevertheless, both in production and prices, the outlook for 1976 and beyond seems to me hardly assured. The vigor of business recovery so far has been heavily dependent on the cessation of heavy inventory liquidation.

Consumer spending, spurred in part by the tax cut, has helped, but sustained growth will depend on incomes generated by other sectors of the economy.

A "normal" sequence for sustained business recovery would look to housing and later business investment to become driving forces. It can happen that way again, but we would be blind to ignore factors that could interrupt the sequence. The renewed sharp pace of wholesale price advances in October is warning enough—if any is needed—that cost and price pressures are still strong and could undermine prospects for continuing strong recovery. Backwash from the financial difficulties of New York City and of New York State and its agencies could complicate the job of financing expansion in markets already suffering from inflation and past excesses.

All of this points up critical questions for the Federal Reserve—questions that deserve answers. To me, the answers to those questions become a good deal clearer—and perhaps not even very controversial—if examined from the longer perspective of the basic functions of the Federal Reserve System. The first of those functions—and the one that attracts so much comment year in and year out—is to maintain overall supplies of money and credit at levels conducive to growth and stability. The second—sometimes almost forgotten except in times of strain—is to ensure the orderly functioning of the credit and payments system through thick and thin and to guard the stability of the banking structure.

Dilemmas or even conflicts can arise in discharging these functions. Today, in providing money and credit we do not face the textbook alternatives of dealing with unemployment *or* with inflation, but we have to face them both at the same time. But, I would suggest, there is a reasonable approach to that dilemma.

I must confess to a certain natural past (and I suspect future) skepticism about announcing money supply "targets" or ranges over a substantial period of time ahead. Set too narrowly and followed slavishly, they may imply too little operational flexibility to meet changing circumstances. As a matter of concept, they may imply a degree of faith in the crudest forms of monetarism—that policy can be set and judged in terms of the money supply alone—that I do not share.

Nevertheless, in the situation we face today, I believe it is distinctly helpful to set out the general dimensions of our intended policies in such quantitative and relatively unambiguous terms. Those making economic decisions—whether businessmen, governments, consumers, or those in financial markets—can then shape their decisions in a context of fuller knowledge about the intentions of the policymakers.

I will not attempt to debate here the appropriateness of the precise numerical ranges, such as the 5-7½ percent growth target range currently in effect for the narrowly defined money supply—whether it could be a bit higher or lower, or whether the range itself is too narrow or broad. But I will defend strongly the general implications of these numbers: The Federal Reserve will not willingly finance new excesses and increases in the rate of inflation; nor will it insist immediately on limiting money growth to rates fully in line with growth of our real productive potential in circumstances where the strong forward momentum of price increases in "the pipeline" must be given some weight.

Over time, a return to price stability necessarily implies a slower growth of money and credit than our present objective. But our present policy of steering between the extremes—a policy that has perhaps inadequately been described as "moderation"—seems to me both clear in intent and fully defensible. And I believe the numerical ranges help provide the longer perspective needed for those of you who try to interpret, literally from day to day or week to week, the significance of the gyrations in reported money and credit data.

In present circumstances, it is worth remembering that it is the second of our functions—to protect the payments system—that was enshrined in the original Federal Reserve Act, adopted after a series of banking crises had disrupted the economy. Essentially, the broad economic policy responsibilities, so much debated in its specifics today, were grafted onto this original function over the years, rather than the reverse. But I assure you this basic statutory function, which demands special concern for the functioning and health of the banking system, is not forgotten.

That continuing concern finds its reflection in part in the day-to-day—sometimes dull but never forgotten—discharge of our responsibilities for the supervision and regulation of banks. The more dramatic, but seldom required, role is sometimes described as the "lender of last resort". Because in recent years recourse to the Fed for credit has so rarely been required on any scale, clarity in our approach in that respect would be useful too.

The law provides the Federal Reserve with only very limited emergency powers to lend to *nonbank* borrowers for rather closely defined short-term liquidity needs. In a sense, the presumption is against such assistance. Consequently, short-term credit for liquidity purposes has not, for instance, fit the particular circumstances of New York City, where the credit need has been for a substantial period, where the budgetary problem has been central, and where the difficulties have not arisen as a result of

market disturbances elsewhere but from basic problems of the city itself.

By statute and policy, the presumption is quite the reverse should the stability of the payments and banking system be questioned; indeed, it is a central legal and policy duty of the Federal Reserve to assist banks in coping with pressures created by extraordinary economic strains and, particularly, to maintain the depository function unimpeded. I emphasize this side of our responsibilities in recognition of the concern that some have expressed about the impact of a default of New York City on the local money market banks. It would, of course, be more accurate to describe those banks as national and international institutions that happen to have their home offices in the city. They hold city securities—slightly over $1 billion in the aggregate. But that amounts to less than ¾ of a percent of their earning assets and to little more than 9 percent of their total capital and reserves.

Should these securities be substantially impaired in value over a long period, there are some obvious implications for future profits. But it is by no means obvious—or perhaps even likely—that serious impairment will last. Doubts on that score have led the supervisory authorities to decide to defer for up to six months following any default a mandatory write-down of the value of those securities. Even then, an unavoidable impact on profits—which have generally risen in recent years—is quite a different thing from the default of New York City affecting the basic stability of the banks; the holdings are simply not that large. The problem, if it exists, would lie in psychological apprehensions, and the classic response of the Federal Reserve would be to act—forcefully and freely—to provide an alternative source of liquidity.

All of this falls in the category of contingency planning.

As matters stand, I have been encouraged in recent days that the state and the city are coming to grips more directly with the budgetary problems that underlie the financial crisis in their affairs. In my judgment, questions about the financial health of the state can be resolved, and the marketability of its securities can be restored in a reasonable time frame. Even now, with the clock running all too fast, the needed combination of stern budgeting and residual financing for the city should not be wholly beyond the reach of those interested in solving the problem and in limiting and containing its repercussions.

Indeed, I would go further. The kind of agonizing adjustments in practices and attitudes the city and state are facing in the most acute form find their counterparts in other areas of our national economic life. While the problems differ in detail and scope, the process will never be quick and painless. But our collective response can lay—is laying—the basis for a return to stability and prosperity.

In business and public life, most of the men and women in this room—and I do not exclude myself—have for a long time seen their horizons and preoccupations extend to the nation and the world. For too long, those few laboring for the financial and economic strength of this city—away from the spotlight and amid the frustrations—have had too little support. Today, we begin to realize a simple truth—that honor and fortune alike rest ultimately on the good health and prosperity of our city.

Out of this travail, I for one believe we can help make New York an example, not of default and decay, but of how to learn from experience, respond to adversity, and restore stability. Call it whether in irony or praise Fun City, the Big Apple, or the Capital of the World, we can be sure that whatever we do here will be more than a symbol. It can be a real turning point, not just for New York, but for the nation as a whole.

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