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Key Problems in Maintaining Monetary Stability

Remarks of

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The concept of "monetary stability" ranks along with that of a "sound currency" as a moral platitude intended to define a good or proper public policy. Both ideas convey the subjective satisfactions associated with firmness and constancy, of a future reward for present behavior, of foreswearing economic indulgence, and of doing good generally.

Public policy, admittedly, needs a powerful emotional anchor if it involves results that transitorily or apparently are hostile to identifiable private or community interests. But public policy also needs a rational anchor which distinguishes between ends and means; it needs an analytical anchor which pins down cause and effect; it needs a judgment anchor which is aware of the limitations of current analytical techniques and perceptive in the use of intuition.

To be specific, monetary stability is not a goal of public policy but a means of achieving some goal such as a rising standard of living, greater stability of personal incomes, economic growth or a better scale of living for future generations. The contribution of monetary stability is limited to its role in making our economic system function better. Most of us believe, looking at the experience of other nations as well as our own, that monetary stability "works" better than monetary instability. However, we must admit, in the light of experience, that the free enterprise system, or some modification of it, is capable of "living with" a certain amount of monetary instability.

The tolerance of our economic system to the many infringements on its free functioning is quite remarkable and, I suppose, each of us has some kind of a priority schedule for what he regards as the greater and lesser perils involved in artificial constraints on the economy, whether they arise from the tax system, administered prices, money management, wage guidelines, or whatever.

The only point I wish to make is that among these infringements, the risk taken of some degree of monetary instability is, of necessity, a matter of judgment rather than of precise analysis or blind faith.

Monetary stability implies somewhat more than price stability but most of the force of the concept is associated with price stability or anticipations of price stability. Only bankers, and central bankers in particular, could be continuously concerned with "monetary stability" if the incidence of monetary instability did not have price and output aspects. It is essential, therefore, to make a judgment about contemporary or prospective price developments.

The price measurements that are available are found in the indexes of consumer and wholesale prices. Both have numerous deficiencies as measures of monetary stability.

The CPI signaled a steady price creep throughout much of the fifties and most of the sixties--in fact, it has been stable only in periods when food prices were falling. This upcreep reflects to a significant degree the difficulty of measuring quality changes in goods and services consumed. The longer the period covered and the more rapid the rate of technological change the less reliable the index becomes as a measure of real change in the price of an unchanging standard of living.

The WPI is a much better index for signaling monetary instability. However, it suffers from the defect of under-reporting price changes because of its reliance on quoted prices for some important commodities instead of actual prices paid, thereby often missing the changing terms and conditions that obtain in actual transactions. As a consequence, this index is sluggish and, at best, a late warning signal.

The adequacy or inadequacy of our price measures has been debated so often and so tediously that, despite its importance, I hesitate even to summarize the pros and cons before this audience At the risk of some caricature of the facts, I think an allegorical treatment may spare us both that rehash

In that vein, then, I start with the well known fact that over the past few years the United States has had a balance of payments problem. We may think of it as a challenge to public policy but some have thought of it as an exploitable business opportunity. One such opportunity was a narrowly circulated, but influentially directed, weekly market letter of a Western European financial concern which used our balance of payments deficit to iterate week after week the phrase "The dollar is weak again today." And in that currency the dollar was "weak again today," month after month, and year after year.

But the economics of the situation were not in any sense accurately conveyed by the phrase The market weakness of the dollar reflected a capital flow that was revitalizing and infusing European economies with American production and distribution techniques Sentiments and judgments inspired by the phrase "the dollar is weak again today" were inimical to the interest of that community even more than ours. Ironically, while this poop sheet pointed at the dollar as a weakening currency the trading position of its principal's country was deteriorating steadily and the robust appearance of its currency long concealed the economic malaise that had set in.

Now, in the United States, the monthly consumers price index has been rising slightly, but perceptibly, in most of the months of the postwar years. Its monthly heralding in the press is, in effect, a little like the use of the phrase "the dollar is weak again today." Over the years there have been times when the judgments implicit in the declaration have been justified, but the sustained impression of a steady price creep implies to the public, at any rate, that Government fiscal and monetary policies have been wrong for a good many years and should have been geared to retarding growth and investment in the interest of price stability.

Most of us doubt that monetary policy can be very effective in compelling the economy to absorb the benefits of technological advances through falling prices, or that monetary policy can cope with the vagaries of the weather, or the timing and duration of either the cattle or hog cycle. And while I, for one, do not object to a price index that can be used for a more egalitarian distribution of wage, salary or retirement income I am deeply concerned that the CPI is being used to condition a community judgment that will opt for policies injurious to the public welfare.

As in the balance of payments analogy, there is irony in the price situation, too, for as the CPI inflates our fears the WPI deflates our apprehensions with its sluggish registering of price developments.

A sensitive reporting system for price changes is primarily to fortify our knowledge and analysis of the contemporary and prospective price developments as they unfold at different speeds in different parts of the economy. Since a certain amount of price movement is taking place at all times--and desirably so, for this is how resources get allocated to more productive uses--we need commodity detail and pricing refinements to distinguish between individual price adjustments that appear to be related to shifts in resource use and those that are responding to over-all demand or to expectations of change in over-all demand.

To a degree the present wholesale price index can be used to measure the pervasiveness of price change, and from these data some judgments can be made as to the weight of inflationary pressures. To give the data meaning in terms of our recent experiences with inflationary developments I have constructed a table comparing four 12-month periods from the wholesale price index components.

The first period I have labeled "Korea"; it covers April 1950 to April 1951, a period in which the wholesale price index rose 18 per cent. I assume there is no disagreement that the proper label to describe this magnitude of change is inflation.

The second period which I have called "Cyclical Recovery" is from June 1954 to June 1955. It exhibits a typical response of the wholesale price index to a more or less normal strengthening in industrial prices as output expands cyclically. The change in the total index was slight in this particular instance because of the decline in foodstuff component but industrial prices rose 1.7 per cent.

The third period I call the Mid-Fifty "Inflation." The word inflation is in quotes because at the time, and since, not all analysts have been in agreement that this was a period when fiscal and monetary policies should have been constraining growth and employment. Nonetheless, in the twelve months from June 1955 to June 1956 the industrial component of the WPI rose 5 per cent--clearly enough of a change to give rise to differences in judgment as to its significance for policy action.

It is interesting in light of many current economic discussions to note that the Council of Economic Advisors in the 1956 Economic Report published just ten years ago described the effectiveness of the monetary and fiscal policies of the time as follows:

Price Changes in Four 12-Month Periods

(Wholesale prices)

	KOREA	CYCLICAL RECOVERY	MID-FIFTY "INFLATION"	MID-SIXTY "TRADE-OFF"
	April 1950 to April 1951	June 1954 to June 1955	June 1955 to June 1956	Sept. 1964 to Sept. 1965
	Per Cent Increase in Weighted Indexes			
Total Index	18.1	0.3	3.6	2.3
Foodstuffs	20.6	-3.7	-0.9	4.4
Industrial commodities	17.1	1.7	4.9	1.6
Industrial materials	21.1	2.3	5.4	1.9
Sensitive	38.8	5.5	5.4	3.5
Other	14.0	1.3	5.4	1.4
Industrial products	11.6	0.9	4.2	1.2
Consumer	11.3	0.3	2.7	1.2
Producer	12.6	2.0	7.8	1.2
	Distribution of Changes in Industrial Commodity Groups			
Number of groups	227	228	229	251
Per cent rising	98	61	79	68
Per cent rising 2 per cent or more	96	36	67	35
Per cent rising 5 per cent or more	92	16	44	13

"Even now, however, it can be said with confidence that the early recognition of a need for monetary and fiscal caution, and the gradual but persistent application of a policy of restraint during the greater part of 1955, contributed in no small degree to the achievement and maintenance of prosperity without price inflation.

"The vigorous expansion of economic activity during 1955 was accompanied by little change in the average level of wholesale or consumer prices. To be sure, the substantial stability of the price level reflected in some degree the opposite movements of industrial and farm prices in wholesale markets. However, the increase even in the average level of industrial prices was not large for a period of high prosperity."

Considering that the price increases which have taken place recently are about one-third as large as those of 1955 it would appear that our "inflation sensitivity" index has risen significantly in the past decade.

I refer to the fourth period, running from September 1964 to September 1965 as the Mid-Sixty "Trade-Off" because while in dimensions it resembles the cyclical recovery of 1954-55 it came after over three years of expansion and in an environment in which significant gains were being made in economic growth and the reduction in unemployment. It reflects a period in which the economy was deliberately--so to speak--being pressed toward higher and higher levels of resource utilization.

The table shows change in the weighted indexes and in the distribution of changes in industrial commodity groups. By any measure the Korea inflation stands out--the industrial index rose 17 per cent; 98 per cent of 227 commodity groups were rising; 92 per cent rose 5 per cent or more. The contrast with the

Mid-Sixty rise is sharp--in that period the industrial component rose 1.6 per cent; 68 per cent of 251 industrial commodities were rising but only 13 per cent rose 5 per cent or more.

My attention has also been called to a table in the January Survey of Current Business in which price changes for 1,418 industrial commodities are compared from October to October in each of the past four years. The results for 1964-65 are roughly similar to those in my table--50 per cent of the commodities rising, 16 per cent by more than 5 per cent, 30 per cent unchanged, and 20 per cent decreasing.

In reciting these price statistics and relationships I may appear to be laying the groundwork for minimizing concern for the potential of price inflation in 1966 On the contrary--this record shows, within the sensitivity limitations of the WPI, only what has happened--not what is happening or about to happen. Expectational forces today are very strong--probably stronger than the real economy and certainly stronger than the consumption sector.

When we look at the real economy's performance we find it is setting records in production and employment considering the levels that the expansion had already achieved. Industrial production rose at an annual rate of 13 per cent in the fourth quarter and on into January; non-agricultural employment was rising at a 7 per cent annual rate. GNP rose by $16 billion in the fourth quarter, almost as much as in the first quarter of the year when the effects of the automobile and steel strikes shifted output from the past and the future into a temporary surge. Inventory accumulation in the past quarter at a rate in excess of $10 billion set some sort of post-Korea record, considering it took place as steel stocks were being adjusted downward and strike conditioning influences were absent.

In December and January, capacity utilization for manufacturing as a whole was above the fourth quarter average of 91, and for some of the material producing industries--specifically, nonferrous metals, paper, and textiles, the pressure was greater. These high rates of operation have increased the risk that price increases will be more pervasive in 1966 and that the industrial average will rise at a faster pace.

It may be that steel and aluminum prices will be held down and that would be a significant departure from the mid-Fifties when steel provided pervasive upward pressure. It is difficult, in any event, to visualize steel prices rising 10 per cent as they did from mid-1955 to mid-1956 and again in the succeeding twelve months.

As I see it, the threat of inflation today is lodged in current inventory policies and defense spending expectations. The extent to which the former continue and the latter are translated into capital spending, or even capital financing, will measure the pressures of inflation in the coming months. The critical judgments are hinged on the degree of economic stimulus from the war in Vietnam. As this becomes clear, it will confirm or invalidate today's expectations.

Among the problems involved in maintaining monetary stability, evaluating the evidence from economic developments that inflation threatens is of major importance and, in some circumstances, by far the most difficult. Once the diagnosis is in, the other matter of high ranking importance is what to do about it; and, to put it bluntly, what to do about it without unduly jeopardizing economic stability.

Given a public consensus that stabilizing action is needed, there is seldom any lack of alternative methods for retarding expansion. The problem is to select the one, or the combination of methods, that will be most effective. It is widely recognized that monetary tightening is not the only alternative. In today's climate, proposals to raise personal and corporate taxes, to reduce non-defense spending, or even to cut back on defense spending, are advanced as measures to preserve monetary stability

At other times and in different circumstances proposals have been made for highly selective constraints on sectors of the economy which seem to be expanding abnormally under the stimulus of false expectations, previous constraints or just plain speculation So we have had credit restraint by law, or agreement, for consumer credit, housing credit, stock market credit and foreign investment And since we have used taxation to stimulate private investment and consumption deliberately and, in some degree, selectively--these steps could be reversed for the contrary reason

While it seems clear to me that diagnosis and the prescribed course of treatment for monetary instability encompass the key problems for public policy, there are some other problems of intriguing if not of key significance. For example, is monetary stability threatened in some way by recent developments in financial intermediation, including the spectacular growth in bank time deposits and the heightened competition among bank and nonbank intermediaries for savings and rate conscious money and near-money stocks? Are our institutions proffering more liquidity than they can deliver or at prices they cannot afford to pay?

Or, to take another tack, what about the nation's banking structure? Does it have the flexibility and dimensions to perform the tasks expected of it? Does confining individual banking units to a single locality or region bring into being circumventing practices and policies that have destabilizing implications?

There are no clear and unequivocal answers to these questions in my opinion, but it does make sense to redouble our efforts better to understand the less obvious but broader effects emerging from environmental and institutional changes in banks and banking.

There is time to mention in these brief remarks one other matter bearing on the problem of monetary stability. A month or so ago I spoke to the American Economic Association on the banking implications of a "cashless and checkless" society indicating that automation in this field would have revolutionary effects on banking. It is appropriate to mention here a parallel development of improving technology in economic analysis, not likely in the immediate offing but in longer run prospect, namely, push button central banking--the millennium for the central banker and also his functional demise.

There are, of course, some economists and bankers who feel the push button era should be with us already--in fact, they've designed the buttons and the circuits connecting the automated central banker to the economy. Their uttons are variously labeled "money supply, narrow," "money supply, broad," "total bank credit," "total bank reserves," "interest rates," etc., etc. And there are some other alchemists' preparation said to guide the more intuitive of us.

All of these monetary analysts, including the pseudo types, have some theory of monetary causation including an a priori or empirical finding of at least how much time elapses between monetary action and final spending or inflation. Unfortunately, no such theory has been demonstrated to have, in changing institutional and economic environments, sufficient validity to warrant its adoption as an unvarying base for policy formulation. Monetary actions continue to require a very large element of intuitively based judgment, trial and error probings, and constant review in the light of evolving expectations.

It would, of course, be a great boon to monetary policy if analytical techniques could determine within usable limits the manner in which monetary restraint or ease works its way through the economy and how long, given the circumstances, before the degree of tranquilization or stimulation sought is achieved. Studies of monetary linkages will, some day, afford better operating guides than we now have. And we should press forward as vigorously as possible to develop scientific substitutes for intuition and judgment predicated on an eclectic use of monetary magnitudes. When the day comes that the scientific know how is available we can "dial" more or less monetary stability in the certain knowledge of its influence on the basic goals of our economic system.