CURRENT PROBLEMS IN DOMESTIC ECONOMIC STABILIZATION

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In recent years, much has been said concerning the art of "fine tuning" the economy through the use of fiscal and monetary tools. Yet, it seems that those entrusted with these tools are probably as far from "fine tuning" the economy today as I am when adjusting the picture on my television set. Generally, by trial and error I find a usable picture, but seldom is it the sharp, clear image that the ads promise.

Much of the enthusiasm for "fine tuning" the economy developed following the tax cut of 1964. Although the economy had been expanding for several years, a significant volume of resources remained unemployed. It was widely felt that additional stimulation was desirable. After much persuasion, Congress cut taxes at a time when substantial budget deficits already existed (an almost unheard of experiment). Shortly thereafter, increases in spending, production, employment and income began to accelerate about as the advocates had predicted.

The degree to which the tax cut in mid-1964 was responsible for the quickening in economic activity will not be examined here. Suffice it to say that about a month after the tax cut was enacted the Tonkin Gulf affair occurred and a major build-up for Vietnam followed to put heavy claims on our productive resources. Also, monetary actions had turned more stimulative about mid-1964.

The enthusiasts for controlling the economy within narrow limits would not admit other explanations. They had advocated a policy; it was adopted, and the expected results followed. For them a new era had, indeed, dawned. It was overlooked that although this action was initially advocated in the "Economic Report of the President" in January 1962, and would have been even more appropriate at that time, it was not made effective until two and one-half years later in mid-1964.

Some advocates of "fine tuning" by fiscal actions are becoming disillusioned on this timing issue. It was a slow and tedious process to get Congress to enact the tax cut, but it seems even more of a task to obtain a tax increase. Since late 1965 the economy has obviously needed fiscal restraint (a tax increase or less Government spending), but Congress has not acted. It is now becoming evident that military, welfare, and political considerations prevent measures desirable for overall economic stabilization from being adopted to the proper extent and at the appropriate time.

As a result of this recent experience, more reliance is being placed on the role of monetary policy in "fine tuning" the economy. Here, it is alleged, is a tool whose managers are experts in stabilization. They meet almost continuously and are able to adjust their actions very finely. It is believed that they have few other responsibilities to distract their attention. There has also been a revival in confidence in the power of the monetary mechanism after its virtual demise in the 'thirties and 'forties. Did not the economy slow in early 1967 following a period of monetary restraint despite a very stimulative Federal budget? Let us now examine the problems encountered in "fine tuning" the economy by the monetary mechanism during 1967 and early 1968.

Monetary growth during 1967 was very rapid, the largest in over two decades. From January 1967 to January 1968 total reserves of member banks increased 10 per cent. By comparison, reserves rose at an average 3 per cent annual rate from 1957 to 1966.

The money supply of the country -- demand deposits plus currency -- went up 7 per cent in the twelve months ending this January. From 1957 to 1966 money rose at an average annual rate of 2.4 per cent.

Total commercial bank credit outstanding increased 11 per cent from January last year to January this year. By comparison, bank credit grew at 7 per cent per year from 1957 to 1966.

By most aggregate measures this country experienced monetary conditions that were extremely expansionary from early last year until early this year. In evaluating the contribution of these conditions to economic stability, one must also examine other forces acting on the economy during this period, such as fiscal measures. Then, too, the performance of the economy itself must be reviewed.

Fiscal actions of the Government were extremely expansionary in 1967 and early 1968. Spending rose for both the war and welfare programs, while tax rates remained essentially unchanged. The high employment budget, which separates the effect of discretionary Governmental actions on the economy from the effects of the economy on the budget, was at its most stimulative level since World War II---over $11 billion in deficit. Preliminary data indicate that the deficit continued near this level in early 1968. This is about $10 billion more stimulative than in the 1966 period, and over $20 billion more expansionary than the average of the 1960 through 1965 period.

At the beginning of 1967, following nine months of monetary restraint, economic activity was on a plateau. Total spending for goods and services rose at a 2.2 per cent annual rate from the fourth quarter of 1966 to the first quarter of 1967, the slowest rate for a quarter since the last recession in 1960. Real production of goods and services actually declined very slightly during this same quarter.

In the late spring of 1967, economic activity began expanding, as expected when both monetary and fiscal developments are very expansionary. At first, the upturn was slow and hesitant, but as the year progressed it gained momentum.

Total demand for goods and services has been rising at about a 9 per cent annual rate since early last summer. Sharpest increases have been in outlays by businesses and Governments, but consumer spending has also climbed despite much talk of a higher saving rate.

Real output of goods and services has gone up at about a 5 per cent annual rate. Since productive capacity has risen at a rate of about 4 per cent, unemployment has been reduced. Women have been attracted into the labor force, and idle plants have been put into operation. Many firms are operating at near effective capacity.

The sharper rise in spending than in productive capacity has placed upward pressures on prices, caused a worsening in the nation's balance of payments and encouraged international speculation against the dollar. Since the second quarter of last year, the overall price index, the GNP deflator, has risen at a 4 per cent annual rate.

Most economists agree that total spending on goods and services has been excessive since last fall. Why, we might ask, was monetary action continued at such a stimulative pace while the economy was overheating and developing excesses and imbalances? The answer to this question may provide some insight into the ability to "fine tune" the economy by monetary action. To respond to this crucial question, let us examine several subperiods of the past 15 months.

The first period might cover January through June of 1967. In retrospect, it appears that expansionary monetary actions were entirely appropriate in this period, contributing to optimum utilization of our resources. As noted previously, the economy paused in early 1967. Production declined, and many thought the country was on the threshold of recession. In the April 1967 issue of the St. Louis Bank Review the question of "Economic Plateau or Downturn?" was examined with the conclusion that "this question cannot be conclusively settled at this time (early April)." In view of the slack in the economy and the widespread fear of a recession, historians will no doubt conclude that the stimulative monetary actions during early 1967 were appropriate.

A second period might run from sometime in June to late November of 1967. During this period spending accelerated rapidly. Even though there was a major auto strike, output rose, unemployment declined, and inflationary pressures intensified. Most analysts concluded that the economy was developing excesses. Nevertheless, monetary actions continued to be very expansionary.

As early as the May 23 meeting of the Federal Open Market Committee, the published record quotes me as having "expressed the view that monetary policy had been highly stimulative thus far in 1967, that fiscal policy was providing an increasing stimulus, and the economy was responding relatively quickly. On the ground that a marked increase in demands for goods and services was likely later in the year and that monetary actions had their main effects after some time lag, I thought some firming in the money market should be sought now to guard against the development later of excessive demands and associated inflationary pressures."

Why, then, did money developments continue to be stimulative in the summer and fall last year? In short, the monetary managers faced a large number of other issues which placed constraints on their actions.

The first constraint was one of knowledge. During the summer months, analysts could not agree on whether or not economic activity was quickening. Data are available only after a one or two month lag, and since most economic time series contain irregular fluctuations, it is dangerous to rely on figures for only one or two months as a signal for the beginning of a new trend. My statement in May was based chiefly on past relationships of expansionary monetary and fiscal actions to changes in the growth rates in spending. There were few solid business statistics to support the belief of an economic upturn during the early summer. Therefore, I cannot criticize others who had honest differences of opinion on the course of the economy for retaining the policy of continued monetary expansion in the early summer. This lack of ability to determine the strength of economic activity promptly is a serious limitation on our capacity to "fine tune" the economy.

Sometime in late summer when it became abundantly obvious that the economy was strengthening, another knowledge constraint emerged. In the initial months of the upturn, there was great uncertainty over how much monetary restraint, or more properly how much withdrawal of stimulation, the economy could withstand without reverting to less than acceptable rates of growth. Even after activity began expanding at a fairly rapid rate, some felt that it was preferable to continue the stimulation and run a risk of excessive demands than to tighten and run the risk of inadequate demand. This lack of knowledge of the effects of alternative monetary actions on the economy was another limitation on the central bank's ability to adapt promptly.

A third uncertainty developed in the summer and fall of 1967 because various financial indicators gave contradictory readings regarding monetary developments. Member bank reserves, bank credit, and money were expanding rapidly, an indication of monetary ease to those who believe that monetary aggregates are the proper guide to monetary influence. On the other hand, most market interest rates rose during the summer and fall, many reaching their highest levels in about 40 years, indicating monetary restraint to analysts who believe that money market conditions are the most reliable guide to monetary influence. The lack of agreement on how to measure the effect of monetary actions caused honest differences of opinion to develop among those responsible for monetary policy determination. Such differences tend to prevent the central bank from responding quickly to changes in economic developments.

Another constraint on monetary managers in the late summer and fall of 1967 was the fear of a financial panic. Recalling the so-called financial "crunch" in the early fall of 1966, there was a considerable school of belief that such conditions should be avoided at virtually all costs. The problem arises because there are many rigidities in our financial system---usury laws, institutional practices, and other limitations on interest rates. Hence, when interest rates rise above certain levels, some activities cannot be financed at any price. When dramatic increases occur in interest rates, most financial intermediaries by borrowing short and lending long, incur sharp losses. Then, too, rapid increases in interest rates usually have a marked effect on residential building and other activities where interest cost is a large portion of total costs.

Conversely, others are much less concerned by the problems of the "crunch." Even in 1966, when I think all agree that monetary actions became unduly restrictive, the financial system continued to operate moderately well. Those problems that did arise were probably caused by the excessively expansionary monetary actions taken earlier which brought about higher interest rates. Other problems were caused by the legal and traditional limitations on interest rates, which should be removed rather than permitting them to hamper overall monetary action. In essence, the problem faced in such periods is one of excessive total demands. Proper monetary actions cause some of these demands to be postponed or withdrawn. In the past this adjustment has been accomplished fairly well. Perhaps, the adjustment might be made more equitable between the various sectors of the economy if there were fewer interferences to the free market, but until the unrealistic limitations are removed, should the benefits of overall stabilization be sacrificed in deference to a particular segment of our economic life?

Honest differences on the possibility of a financial panic undoubtedly led to further procrastination in adopting monetary action to cope with the excessive demands. My own preference would have been to probe a little more aggressively toward monetary restraint last fall. But, others were genuinely concerned that the costs to particular sectors would outweigh any supposed benefits to the overall economy and might even have brought about a downturn in overall activity. Until this issue of the effects of a marked tightening in money markets is settled, a truly "fine tuning" of the economy will be severely limited.

Another constraint on monetary action last fall arose because of a desire for a coordinated application of the various stabilization weapons in curtailing the excessive demands. Even after it became widely believed that aggregate demand was unduly excessive, it was equally widely believed that a chief cause was the stimulative fiscal actions. It was felt that a tax increase (or less Government spending) was urgently needed. Such an action would both remove a powerful stimulant to the economy and by relieving the strong budgetary pressure on capital markets would eliminate a strong upward force on interest rates, making control of monetary expansion easier. Because of the strong belief in the desirability of a tax increase, these advocates favored taking a calculated risk of postponing monetary action in the belief that such a course would be the most likely to encourage Congress to pass a tax increase. Our own view was that the overall public interest lies in the best possible monetary action regardless of what other agencies do or fail to do, but until this question of proper mix of the various stabilization measures and their interim roles is settled, another serious limitation is placed on quick, decisive, monetary response.

Because the Government operated at a large cash deficit, and has a huge Government debt with a relatively short average maturity, there was an almost continuous flow of Government security offerings last fall. These offerings placed another constraint on monetary actions. There is a doctrine called "even keel" which usually prevents any changes in monetary policy in the period from a few days before the Treasury's announcement to a few days after the securities are distributed. The practice has a long tradition in both this country and abroad. At the St. Louis Bank we believe that even keel has been a serious impediment to System action, we fail to understand its advantages to the Treasury, and we urge that the academic community investigate the advantages and disadvantages of this practice. Our studies indicate that as long as the practice of even keel continues, "fine tuning" of the economy by monetary actions will be limited.

Another constraint on monetary action late last fall was the deteriorating British balance of payments. The situation in Britain was serious, and it was felt that any action by this country causing interest rates to rise further might precipitate an additional outflow of funds from Britain. In short, until the world adopts a viable international payments mechanism, another periodic limitation is placed in the way of a quick response of the monetary authorities to solve domestic economic problems.

This is not an attempt to list all constraints on monetary actions, but only to outline some of the major factors which actually caused monetary action last fall to be more expansionary than many of us in the Central Bank would have desired. Until these issues are squarely faced and solved, a rapid adjustment of the monetary mechanism is not likely to occur.

The third monetary policy period I would like to discuss runs from late November of last year to April of this year. The period can be characterized as one of a great deal of action with limited implementation. Monetary policy actions were taken with regard to all three of our monetary tools, but there has been little evidence of real monetary restraint.

Since late November, the discount rates have been raised 1/2 of 1 percentage point three times to a level of 5-1/2 per cent. Although this action had the appearance of monetary restraint, it probably had little real effect. Even at 5-1/2 per cent, the discount rate is below market rates. Funds at the discount window continue to be rationed by the same rules of administration as before; the rate has been no deterrent.

In mid-December, the open market committee adopted a more restrictive policy provided no unusual liquidity pressures developed. Yet, growth in the money supply, which had been at a 7 per cent annual rate, has only slowed to a 5 per cent rate -- still about double the trend growth rate since 1957. In mid-January, reserve requirements of member banks were increased about $550 million. However, in order to prevent undue market pressures from developing during the two week period, open market operations injected a sufficient volume of new funds to more than offset the effects of the higher requirements.

The November to April period was not unusual. During most shifts in monetary policy, there have been lags between the time when policy makers adopted a new policy and the time that it has been effectively implemented. Because of the aforementioned constraints which operate to delay the policy action, there is a great hesitancy to move vigorously once a new course is accepted. Action is taken slowly and continuously in a probing manner in order to attain some monetary restraint but to minimize other problems. Also, some have naive faith that the announcement effects of the new policy, alone, will have the needed beneficial effects. I don't believe that sophisticated money market participants are that easily fooled.

A fourth period of monetary developments will be touched on only briefly. Since mid-April of this year, it appears that real monetary restraint is developing. Although data are still scanty on most aggregate measures of monetary actions, most of those involved in making monetary policy appear to be convinced that the problems of excessive total demand are so serious that action is desirable despite the risks discussed. Although this period has been brief and the effects may not all have emerged, an early evaluation indicates that many of the earlier concerns with regard to adopting the policy shift have not occurred.

In summary, there were many constraints on a quick monetary response to the changing economic developments of the past year. The lack of knowledge about the course of economic activity and monetary effects was a serious limitation last summer. We at the St. Louis Bank, and those in other parts of the System, are conducting many research studies designed to increase our understanding. This is essential if monetary action is to be improved.

The hesitation to move toward monetary restraint because the effects may bear heavily and unreasonably on particular sectors, such as financial intermediaries and home construction, does not impress us as a valid excuse to fail to do what is in the overall public interest. Our studies indicate that most of the problems in these sectors have been caused by market imperfections, such as rate regulation, and not by monetary developments. Our studies also show that excessive monetary expansion with the accompanying rises in prices and nominal interest rates are more harmful to the housing market than a policy designed to provide a more moderate growth in total demand and fewer inflationary pressures.

The hesitation to adopt appropriate policy in order to improve the chances of obtaining a desired tax action seems to us unjustified. The central bank's responsibility is monetary policy. I do not have much faith in the System's ability to conduct monetary policy in such a way as to guarantee the adoption of responsible fiscal measures.

Similarly, we fail to understand the great need to stabilize the money market during periods of Treasury financings, or to deviate from sound policy because of the periodic problems arising from international movements of funds.

In short, monetary authorities, in our opinion, should determine policy on the basis of maximum contribution to overall economic stability and growth. It should not subordinate the overall public interest to the excesses of other public bodies or for the benefit of particular private interests.

The experience of the past year indicates that a "fine tuning" of the economy by the monetary mechanism still leaves much to be desired. In addition to the recognized problems of our ability to forecast and the lags of monetary effect, there are tough problems of choices monetary managers must make in formulating policy. As I pointed out there were many real issues presented to the monetary policy makers during 1967. Differences of opinion existed on how much weight should be placed on these constraints by the various participants. Until these constraints are resolved, a quick response by the monetary authorities to a change in economic conditions is not likely.

The potential of the monetary system for providing a quick countervailing force to undesirable economic developments has not been attained. As a result, perhaps we should forego some of the claimed benefits of "fine tuning," which have been largely illusory and at times destabilizing. Alternatively, monetary authorities might strive for a steadier rate of growth in bank reserves, bank credit, and money. Such actions would contribute to economic stability. They may not achieve the ideal "fine tuning " however, they would be considerably more stabilizing than our past stop-and-go actions hindered and slowed by constraints and the lags of effect.

Please do not interpret this proposal as being in the Friedman uniform rate of growth in money school. We at the St. Louis Bank do not suggest that in periods of severe recession or excessive boom that varying the rate of monetary growth cannot contribute to economic stability. We merely suggest that, in an aggressiveness to seek an optimum level of economic activity at all times combined with the constraints imposed on reversing these actions, monetary developments have, many times, been more destabilizing that stabilizing.

Meanwhile, we suggest a strong program of research for improving the monetary mechanism so that it may become more adaptable in the future. In this research, the academic community can be of great help in investigating and analyzing these constraints to stabilizing actions. Until they are eliminated or greatly reduced, a true "fine tuning" of the economy by flexible monetary action is not likely.