HOW CONTROL OF SHORT-TERM INTEREST RATES CAN LEAD TO RECESSION

Address by
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I'm pleased to be in Oklahoma City and to have the privilege of addressing this distinguished group of citizens who share a deep interest in the economic future of our society. I accepted your invitation with enthusiasm, because I feel that the great issues of monetary policymaking are high on the national agenda these days and I believe that intelligent resolution of those issues depends on a free and open dialogue among economists, political leaders and interested opinion-molders such as you who comprise this audience.

As leaders in your business community, you are all well aware of the difficult monetary policy decisions facing us all at this moment in our history.

National concern about monetary policy has intensified at a time when most indicators show the U. S. economy to be recovering quite well from the recession of the early '70's. Since the trough of the recession in the first quarter of 1975, the Nation's output of goods and services has risen 5.7% a year, substantially faster than the post-World War II average annual growth rate of 3.5%. Inflation has slowed to a 5.6% annual rate from the double-digit days of 1973 and 1974. Corporate profits are increasing at an annual rate of 27.1%, and 58% of the working age population is employed, a percentage that hasn't been exceeded in more than 30 years.

Yet in spite of this better-than-average rate of recovery, the prevailing mood about the economic future of this country is anything but optimistic. Observers of the economy, particularly those in the private sector, seem to be engulfed in a spirit of pervasive gloom. The stock market is down; conversation at business luncheons is bearish, even after three martinis; the traditional American optimism in the future is lacking.

A reflection of this attitude is the disappointing rate of capital spending by industry. During the past 2½ years, the Nation's investment in plant and equipment has increased at an annual rate of only 3.7% compared with an average rate of 7.8% during the first ten quarters of four previous recoveries.

Many economic analysts interpret the unwillingness of the business community to invest in the future to be a result of uncertainty . . uncertainty over changing government regulations, uncertainty as to the new tax program, uncertainty regarding fiscal policy,

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and uncertainty as to the future course of monetary policy, especially as it relates to inflation and interest rates. While we in the Federal Reserve have little involvement in the formulation of political and fiscal decisions, we do have a very real responsibility in monetary policymaking.

This evening I would like to concentrate on two monetary policy alternatives currently facing the Federal Reserve. Newspaper articles, which appeared last month in two highly respected, nationally-renowned journals, illustrate well the options facing us. The first appeared in the Wall Street Journal under the headline, "Fed's Failure to Keep the Money Supply in Line Draws Wide Criticism." The article quotes a variety of Congressmen and economists who claim that the Fed has lost control of the money supply and is permitting monetary aggregates to rise too rapidly. If accelerated expansion of the money supply continues, these critics warn, the rate of inflation will increase and the risk of recession will be "enhanced."

The second article was an editorial in the New York Times which argues that the Fed has become obsessed with one objective: the reduction of inflation, and that instead of worrying about excessive expansion of the money supply, we should concentrate on keeping short-term interest rates down.

These articles reflect a classic disagreement among economists. On one hand there are those who believe that any increase in short-term interest rates threatens to abort economic recovery. On the other, there are those who believe that inflation, as the inevitable result of monetary expansion undertaken to hold down short-term rates, is a greater threat to the attainment of the ultimate economic goals of full employment and general prosperity. Implicit in this disagreement is also the issue of whether the achievement of immediate political and social goals is worth the sacrifice of the same goals in the future.

Let's consider these options from the point of view of monetary policy. What is involved in controlling interest rates?

An interest rate is a price . . . the price of credit. When demand for short-term credit increases, short-term interest rates tend to increase.

Now the Fed has it within its power to counteract increases in short-term rates, at least temporarily, and thereby, to provide temporary stimulus to the economy. It can

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do this by purchasing government securities in the open market.

To pay for securities it purchases, the Fed essentially writes checks on itself -- checks not backed by deposits of any kind. When the Fed's checks are presented for payment, the reserves of commercial banks are increased. Commercial banks are, then, able to make loans and investments based on these new reserves. The funds the banks lend are eventually deposited in someone's checking account and become demand deposits which are, of course, money. Thus, the attempt to bolster credit supply and thereby keep short-term interest rates down, has the effect of also increasing the supply of money.

When persistent attempts to prevent increases in short-term interest rates result in an accelerated rate of money growth lasting for an extended period of time, inflation is the inevitable result. This inflation does not occur immediately, however. Instead, it appears with a lag -- about two years after the accelerated pace of monetary expansion begins. In the current context, if the rate of money growth is kept near 9%, the resulting inflation will not become evident until late next year or early in 1979.

Ironically, expansionary policies designed to keep short-term interest rates low ultimately cause long-term interest rates to rise. Lenders, who observe sustained increases in the rate of money growth, anticipate that inflation will erode the real return they will receive on the funds they are lending. To compensate, they increase the rates at which they are willing to lend.

Thus, monetary policy designed to keep short-term interest rates constantly low involves a trade-off. The sacrifice of long-range price stability and long-range interest rate stability is the cost that must be paid to gain the brief economic stimulus that comes from counteracting an upward fluctuation in short-term interest rates.

Now let's consider an alternative . . . what would happen if monetary policymakers were to accept fluctuations in short-term interest rates and concentrate instead on controlling the growth of the money supply in order to achieve stable price levels and stable long-term interest rates. Policy of this sort is based on the assumption that if price stability and long-term interest rate stability are to be achieved, growth of the money supply must be contained at about the same rate as growth of the productive capacity of the economy. When money grows more rapidly than productive capacity for a prolonged period, inflation is caused; if the money supply were to grow more slowly than the

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economy's productive capacity, deflation would result.

Those who believe that monetary policy should concentrate on long-range price stability observe that during the past six months the narrowly-defined money stock, M1, grew by $10 billion or at an annual rate of 9.7%. They consider such growth to be excessive and believe that if maintained for much longer it will inevitably add to the rate of inflation.

On the other hand, those who believe monetary policy should concentrate on keeping short-term interest rates down observe that during the same six-month period, short-term interest rates rose 200 basis points. They blame this rise in interest rates on tight control of the money supply and predict that the result will be the end of the current recovery.

Unfortunately, we can't have it both ways. We must make our choice. We can either choose a monetary policy that creates an immediate illusion of prosperity but in the process causes inflation which ultimately leads to high long-term interest rates. Or, we can choose a monetary policy that permits the market to determine short-term interest rates and concentrates on establishing stable price levels and stable long-term interest rates.

Those who believe monetary policy can have it both ways at the same time - - - can control interest rates in the short-run and provide stability in the long-run - - - are sadly mistaken. A monetary stimulus, once built in, will produce future increases in price levels no matter what kind of policy is pursued in the interim.

I, for one, do not believe that increases in short-term interest rates of the scope we have been experiencing will push us into a recession. I do, however, believe that excessive monetary growth at this time of strong credit demand, will stimulate inflationary expectations which will lead to higher long-term interest rates and, ultimately, an accelerated rate of inflation. The anticipation of inflation and a consequent increase in the cost of long-term financing have far greater recessionary implications than rises in short-term rates. In my opinion, monetary policy should be concerned with the long-term stability it is uniquely able to provide and not with uncertain transitory benefits that are attractive only because they are immediate.

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There are those who would criticize this point of view as reflecting a lack of concern about unemployment and other problems of social concern. I am as concerned as the next man with the solution of society's problems, but I believe that policy which provides long-term stability is the best way to achieve the economic growth necessary to create jobs for the unemployed and offer escape to those trapped in poverty.

It is crucial to keep in mind that we are not talking about a trade-off between inflation and unemployment. Just as monetary actions have only a temporary effect on production, they have no lasting effect on employment. The amount of unemployment we will have in the future is not influenced by how much money we create today. Those who advocate excessive monetary growth are opting for a temporary reduction in unemployment today at the expense of more inflation tomorrow.

No monetary magic can assure achievement of all of our social goals, but monetary policy can make an enormous contribution if it leads to a stable economic environment in which a hardworking, self-reliant, enterprising people can achieve those goals.

Policy dedicated to prudent control of money growth is the best means of attaining the long-term stability necessary to eliminate the uncertainty now standing in the way of economic expansion. Monetary policy that vacillates with each fluctuation in the Federal funds rate can only perpetuate that uncertainty.

Finally, may I touch on the role of the Federal Reserve in dealing with these issues? As you know, the Federal Reserve conducts monetary policy through the Federal Open Market Committee, a body consisting of seven members of the Board of Governors and the Presidents of the twelve Reserve Banks, five of whom are voting members at any particular time. These individuals meet monthly in an effort to guide monetary policy in the best long-term interests of the Nation. They set ranges for monetary aggregate growth and ranges for Federal funds interest rates.

In recent months, as on other occasions during the more than sixty-year history of the System, the Fed has been subjected to increasing criticism. The most recent criticism has emanated both from those who feel that the FOMC has not maintained a tight enough lid on Federal funds interest rates and from others who feel that the Fed is not controlling the rate of money growth tightly enough.

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· Certainly, monetary policymaking should not be immune from public scrunity or from criticism when criticism is justified and is based on objective judgment. Criticism serves no constructive purpose, however, when it is political in nature and based on considerations of short-term expediency rather than long-term economic stability.

The Federal Reserve since its founding more than sixty years ago has been successful in resisting political pressure because Congress established the Federal Reserve in a manner specifically designed to shield monetary policy from political influence. Imagine, if you will, the consequences if Congress were to abandon its wisdom of the past four decades and subject monetary policy to direct political control, as some now urge. If the Federal Reserve were to lose its independence in the area of monetary policymaking, sober appeals for monetary restraint would be drowned in a din of strident populist demands for accommodation and easy credit. The rampant inflation that would follow would end, inevitably, in a severe recession that would swell, rather than reduce, the ranks of the unemployed and mire millions of Americans in oppressive poverty.

If we are to achieve our ultimate economic goals of full employment and general prosperity, we must maintain a monetary authority with the necessary independence to plan in the best long-term interests of the Nation and permit that authority to pursue its policies with a minimum of interference from without.

In closing, I think it is appropriate to consider where we as individual citizens fit into this picture. Abraham Lincoln once spoke of the great test that confronted this Nation in his time . . . a test of whether a nation dedicated to equality among men can long endure. Ten score and one year after its inception, the American experiment is again passing through a period of trial. Today, we face a test of whether a nation governed by the people can endure amid the baffling complexities of twentieth and twenty-first century living.

If we are to preserve our free institutions, each of us as individuals must strive to unravel for ourselves the complex issues upon which we must make collective decisions. We must involve ourselves in the governing process and never lose sight of the fact that each of us is a vital cog in the destiny of society as a whole. No law or government requlation, no fiscal or monetary policy decision, by itself, has ever harvested a bushel of wheat, produced a barrel of oil or housed a single family. It takes people to get the job done!

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I don't mean to say laws and institutions are unimportant. Far from it. Imprudent laws and unwise policies that inhibit individual initiative can be extremely detrimental to the national interest. What I do mean to say is that no matter how complex our society becomes, no matter how sophisticated we may think our fiscal and monetary tools have grown, all our material wealth results, ultimately, from the productive efforts of individuals.

For 200 years we Americans have lived in freedom and prospered through private enterprise to an extent unprecedented in all the preceding millenia of human history. We hear much today about our national failings, and undeniably, we have our faults. But I believe we remain basically the same hardworking people who built this great Nation. I believe our faith in private enterprise, although it may have waned temporarily, has not been lost. And I believe the same capacity for self-government that has enabled us to endure countless past crises will enable us to preserve our liberty through these unsettling times.

Perhaps I am an optimist. For I, for one, am unwilling to accept the doctrine of those who say that America has "had it" . . . that the free enterprise system that has brought us the highest standard of living of any society in the history of mankind is no longer capable of coping with the challenges of today's world.

An independent Federal Reserve System dedicated to supporting the economic principles which have served us so well in the past is an essential element in assuring our continued growth and prosperity.

I hope that these remarks have underscored the important role the Fed has to perform. And I hope that you, as involved members of the economic community, will support our efforts to the extent that our performance merits your confidence.

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