FOR RELEASE ON DELIVERY
THURSDAY, OCTOBER 25, 1979
2:30 p.m. E.S.T.

THE ECONOMY AND THE COURSE OF MONETARY POLICY

Remarks of

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before the

Washington Forum's Tenth Annual Symposium

Washington, D. C.
October 25, 1979

The Economy and the Course of Monetary Policy

The developments in the United States economy in the first eight months of 1979 were such as to raise questions in some peoples' minds that we had topped out the post-war's seventh business cycle after a sustained upswing from early 1975, and that some forerunners of recession might be appearing on the horizon. It is interesting to note that since January of this year gross national product, industrial production, and retail sales have been virtually unchanged on a real basis. The GNP declined in the second quarter of the year but the gains in the first and third quarters would appear to have virtually eliminated the effect of the second quarter's decline. Industrial production similarly climbed slowly in the early part of the year, fell sharply in the second quarter, and then rebounded in the third quarter. Retail sales on a seasonally adjusted real basis were down modestly in the first three quarters of 1979. But total employment showed continued evidences of growth during 1979 and the unemployment rate hovered just below 6 percent. Total employment in the United States expanded to record levels of nearly 100 million people. Construction activity slowed in the early part of 1979, hit hard by the winter weather and by the effects of the trucking strike and shortages of gasoline. But overall the nation's economic activity has remained at a high level so far in 1979.

On the other hand, the financial side of the nation's economy during 1979 has shown high volatility and engendered great caution as to the future outlook. In the early part of the year there was a flat to declining money supply and strength in dollar foreign exchange relationships, but these factors reversed to a rapid rate of money supply growth and a deterioration in exchange rates in the second and third quarters. Of special difficulty were the unusually large declines in the exchange rate of the dollar against the Deutche-mark and the large gain of the dollar against the Japanese yen. Throughout the period, but accelerating in the third quarter, was a strong bank credit demand, especially from consumers and business.

Also through the entire period there was a high rate of inflation in the United States, fed partly by the increases in oil prices and partly by the impact of demand. In the retail area inflation hedge buying persisted in the housing market, and developed in other hard goods and hard metal markets. On average, the inflation rate moved from about 9 percent in 1978 to more than 13 percent in 1979, and no evidence of easing in such price levels has yet surfaced. The economy began to suffer from business and consumer decisions on inventories, borrowing, advance buying, and basic speculation, fed by expectations that prices would either maintain their current rate of advances, or perhaps even accelerate.

Thus by the end of September the nation was faced with an economy still operating at near-record levels with high employment levels, a declining rate of productivity, a fairly steady rate of unemployment, and growing speculation against the dollar, both at home and abroad. Fiscal policy continued in a deficit position, though the deficit was reduced somewhat during 1979. At the end of the third quarter, it was evident that speculation in gold and metals markets was rising and was spreading to commodity futures and other means of obtaining a hedge against future inflation. This speculative activity reinforced that which had been evident in the housing markets for some time. All of the above accentuated the need for economic policy moves toward restraint.

Finally, the more than ample availability of credit despite high and rising interest rates, was a factor in calling for intensified restraint on the U.S. economy. Businessmen and consumers were making economic decisions based upon expectations of further inflation, and were willing to borrow even at steadily higher interest rates.

Why do we find ourselves in such an economic bind? Why are prices rising so rapidly? And why can't we take hold of our own economic destiny? We all look for scapegoats. To some, the cause of the whole problem is the OPEC pricing for its oil. To others, the problem lies in the hands of foreign nations who have bid down the price of the American dollar against their own currencies, and have been able to mitigate the problems of rising oil prices by an appreciating currency. To still other observers, the problem lies at home, with government budgets in deficit and the central bank providing too many reserves. And finally, to some, it is just the sign of the times that over a long period we have overspent and have underproduced.

It is probably a useless exercise to attempt to assign the blame for our current economic malaise. But to the extent that it does shed light upon our problems, one should at least consider a few of the following points. First, it is true that the petroleum exporting countries have raised their prices rather dramatically, both in 1974 and now in 1979. In reviewing these increases, one must recognize that the price of oil scarcely moved at all for many years before 1974, and moved very little from 1974 to 1978. In both instances, the prices of other materials, goods, and services were moving upward with a considerable cumulative impact. To the oil-producing country, the irreplacibility of the raw material which they can produce and sell to the world means that their source of export earnings will eventually dry up, and they wish to maintain at least a current equality of purchasing power for their primary export.

But perhaps more fundamental to the basic cause of inflation in the United States has been its steady increase in government activities, paid for partly by taxation, but also by heavy deficit spending, which eventually meant inflation. Over various periods of time, the central bank did provide too much money to encourage price stability. But the unevenness of money supply growth could scarcely have been the continuing cause of the inflation of the United States. Nor could it be the short-run impetus that we have seen in the past few months. Indeed, we in the United States are attempting to live at the high end of the standard-of-living spectrum without providing for future energy sources and without providing the wherewithal for significant expansion in our productive capacity. The wherewithal must come from basic savings and capital spending. But savings in the United States are averaging only about five percent, whereas in other major industrial countries such savings are significantly higher, even above 20 percent. These savings provide the basic funds in a non-inflationary manner to enable businessmen to borrow for capital expenditure purposes. We not only do not save enough, but we put roadblocks of regulation and legal challenges in the way of our businessmen who wish to enlarge their capacity, or improve their technology. We almost penalize the entrepreneur who wishes to improve his business and indeed indicate to him that such expansion may be third or fourth in the total priorities of this nation.

Finally, we as an American people share the blame also, for we are the ones who send our problems to Washington, who demand a central government solution, who demand that the central government take the funds to meet most of our problems, and have left the problem-solving to the federal, not the state, local, or even personal level. We seem to have lost some of our self reliance, some of the capacity for problem-solving at our own level, and instead are looking more and more at the Federal Government to solve our problems.

Regardless of the cause of the current situation, most of us are interested in the fundamental question of how can we extricate ourselves, and at what cost. In other words, what policies can be adopted which will restrain inflation, permit the continued expansion of the U.S. economy, permit high and rising levels of employment, enlarge job opportunities, provide continued growth in personal incomes, and protect the value of the dollar abroad. Traditionally, in the United States and in virtually all economies the methods of restraint to curtail inflation are those tied to the monetary and fiscal policies of the nation. In the United States, fiscal policy has been a slow and cumbersome weapon available really only for long-term correction to improve the balance in the economy and to encourage long-run goals, not as a weapon against short-run inflation. Thus, the usual front-line soldier against inflation is the central bank, and in the past month it has performed its traditional role with particular forcefulness.

Why haven't we been able to curtail this monster of inflation before it got out of hand? Why were we willing to accept the steady increases in demand and the pressures on capacity in our industries, and the rising level of debt and consumption before they created such inflationary pressures? Why have we been willing to continue our wasteful ways in energy consumption, and why haven't we curtailed that consumption, voluntarily, or through mandatory action? Some of the answers must be found in the policies of our government, policies designed for long-run correction of the problem, policies which procrastinated with the impact of inflation, policies which attacked the problem slowly without careful measurement of the cost of such gradualism. Had we, for example, increased our restraint on the American economy in 1978, we might not have had the very large run-up in oil prices in early 1979, and might have held our level of inflation below the double-digit point in this year. But in 1978 people were already talking about the possibilities of a recession, about the possibilities or potentials of future increases in unemployment, and about the problems such a recessionary tendency would create. And the political answer was to approach the restraint needed on a gradual basis. Gradualism permitted the further growth of inflation, and the nation's economy expanded at more than a five percent rate of growth in gross national product in the fourth quarter of 1978. Gradualism meant more inflation, which sparked another round of higher OPEC prices. Gradualism meant that the expectations of further inflation were to grow rapidly and those who until early 1979 had hopes for a return to stability, began to speculate to protect themselves against inflation. And so the momentum of inflationary expectations grew, and the decisions being taken by businessmen and consumers began to feed upon themselves enlarging the price response.

And so here we are in the fall of 1979, with expectations of higher prices and higher interest rates, and an economy whose rules, regulations and pattern of life are built on stability, but which is suddenly challenged by a problem of rapid inflation. The reactions of consumers, businessmen, and government alike have been too slow. And so in the fall of the year we are now taking those hard actions which, if not supported by all elements, especially the banking system, will condemn this economy to further inflationary pressures, and ultimately a boom-and-bust psychology.

Since the Federal Reserve announced its restraining measures on October 6, I have been most interested to listen to the reactions of individual industries as they sought to find ways to protect themselves against the impact of these restraining measures. The home building industry talks as if it were the end of home building, because interest rates are going up again. But the construction of a home is a long-term asset and can be purchased on a long-term basis. The deferral of some purchases for a few months would scarcely seem to me to be in the category of a crisis. True, the real estate and home building industries are likely to slow down. At the same time, the pressures on the American financial structure will be reduced, and interest rates should ease, but only if those who are seeking the enlargement of their industry are willing to accept slower growth for a time. To the banks, too, that have reacted by saying that they will meet all commitments made in the past, that they will take care of their regular customers, that they will continue their lending abroad, let me say that they, too, are a part of this American scene. Their fundamental assets are in dollars. If they adopt short-sighted policies which lead to further inflation and deterioration of the value of our currency tomorrow, I question whether they have made a very good bargain.

None of us want to go through a period of restraint, or see higher levels of unemployment, or lower incomes, especially discretionary incomes, but if this is the penalty for a free American economy, geared to a free enterprise system in which we as individuals have the right of choice of what we buy, the amount we buy, or when we buy it, then to me a modest slow-down is worth it. One must look over longer periods of time to measure the cost of recessions. It is doubtful that many could say that we in this country do not have a higher standard of living than at the end of World War II. We certainly have more people at work, we have higher incomes, we have more housing and we have more consumer goods. What we lack, and have lacked for the last 15 years, is the drive to improve our own productivity, to save our money for new capital ventures, and to improve job opportunities in production. Very few of us would like to see the United States only a consuming nation with all of the problems that it would entail, especially the lack of power in world economic and political life. And yet the road we are on is the road of consumption, not production. So let us go forth to a new America in the 1980's, go forth over this period of difficulty with restraint, with less complaining, with reduced standards of living for a while to get higher standards of living later on. Let us reduce our special interest demands on the Federal Government. Let us take back some of the problems we have sent to Washington. Let us accept the responsibility of meeting our problems and working them out cooperatively. The 1980's offer a substantial challenge and a substantial increase in responsibility, if we are to avoid the imbalance of a consuming nation by enlarging the production side of our economy.

Finally, let me express a personal view about our current monetary policies. I have been in favor of greater restraint for more than a year and so I clearly favored the Board's action on October 6. However, I am still skeptical about targeting our policy actions on the monetary aggregates even through a surrogate. Over the past nine years we have moved steadily toward greater use of monetary aggregates as a guideline to policy. I submit that the problems of measurement, interpretation, forecasting, revisions and tracking these guides on weekly, monthly, and quarterly bases have cast a significant cloud on their usefulness. Personally I would pay attention to such data only on a semi-annual time period and use our traditional measures of reserves, bank credit, and interest rates to provide the guidance as to the need for Federal Reserve action. I am particularly disturbed by the attention given to weekly money supply data recognizing all of its frailties of composition and estimation. Thus in the current context, I would pay scant attention to currently published money supply data, because the turmoil in the market in recent days can scarcely provide a reasonable guide to the future.

One should not expect the monetary policy actions of October 6--less than three weeks ago--to correct instantly all of the accumulated problems and imbalances of our domestic economy or its relationships abroad. What I hope we have done already is to create uncertainty in the minds of those who expected continuously higher prices and uncertainty in financial markets as the availability of funds to meet all demands, whether productive or not. Down the road we will find out whether the restraint is sufficient to slow the growth of bank credit, to curtail speculative endeavors, and to lower the rate of inflation. It is my hope that it works, for the alternatives are certainly very unattractive.

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