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MONETARY POLICY AND INFLATION

Remarks by

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One of the assignments I have taken on as a new Board Member is to chair the Committee on Federal Reserve Bank Activities. During the next few months I will be visiting each of the Reserve Banks, and some of their branches, meeting as many of the officers and directors of our regional banks as possible. This visit to the Tenth Federal Reserve District is the first such trip. It seems to me eminently proper that I should begin here, since my career at the Fed was launched at the Federal Reserve Bank of Kansas City.

This is one of my first public appearances since joining the Board. I would like, therefore, to take this opportunity to set forth briefly what I believe the Federal Reserve can and should do about the principal economic problem facing our country today-- the problem of inflation. Dealing with so complex a topic in a short span requires one to be more assertive than analytical, and more provocative than profound. Hopefully, you will take my remarks in that spirit.

There are three basic points I want to make. The first is that the ability to use monetary policy as a short-term counter-cyclical tool is severely limited under present circumstances. The principal focus of Federal Reserve policy must be on the long-term goal of reducing inflation. Second, pursuit of such a course of policy does not mean mechanical adherence to predetermined growth rates of the monetary aggregates. Third, even under the best of circumstances, reliance on monetary policy alone to bring inflation down will yield extremely disappointing results. Our long-term inflation problem might not improve, and could worsen, unless a wide range of governmental policies are aimed at reducing inflation as our nation's top economic priority.

Five years ago, our country began to recover from the 1974-75 recession. At that time, the underlying, or hard-core, inflation rate was about 6 percent. By the underlying inflation rate, I mean the long-term trend rate of increase in unit costs of production, or in the broad range of industrial and service prices--that is, prices excluding food and energy. Over periods of several years, these measures closely follow one another.

Sometime around the beginning of next year, our economy will begin to recover from the recession of 1980. That recovery will begin with an underlying inflation rate probably in a range of 9 to 10 percent.

We would all agree, I am sure, that another round of acceleration in the underlying inflation rate during the next economic expansion would be simply disastrous --not only for our economy, but also for our social and political institutions. But what can be done to prevent it?

We must not be timid in setting our goals for inflation. It would be a mistake to take as our goal merely the prevention of any further increase in the underlying inflation rate. If we tell the public that inflation rates above 10 percent are unacceptable, but that anything less is satisfactory, businesses and consumers may well begin to borrow and spend in ways that make a higher rate of inflation virtually inevitable.

Our goal must be much tougher. It must be to bring the underlying inflation rate down even as the economy moves from recession to higher levels of economic activity.

This is a very ambitious goal. During each and every economic recovery during the postwar period, the underlying inflation rate has always risen. Moreover, with the passage of time, inflationary expectations have worsened substantially; mechanisms to index wages, social security benefits and other income payments to prices have become more widespread; shocks to prices from the food

and energy sectors have become more common, and for other reasons, also, the inflationary bias in the U.S. economy has increased. Nonetheless, despite these difficulties, history during the forthcoming economic recovery must be stood on its head. The hard core inflation rate must be brought down.

To have any hope of accomplishing that objective, monetary policy must be conducted in ways that are different from the pattern of the past quarter century. Throughout most of that period, the Federal Reserve's principal monetary policy objective was to be a countercyclical balance wheel--to "lean against the wind," as Chairman Martin used to say. That meant using the tools of monetary policy fairly actively to combat recessionary tendencies when they appeared, and to restrain the economy when the degree of slack in labor and product markets diminished to a point where pressures on wage and prices began to threaten.

In an economy in which wages and prices are relatively flexible in both directions, as was the case earlier in the postwar period, that kind of monetary policy can contribute a good deal to economic stability without adding to long-run inflation. If monetary policy is too easy for awhile and the inflation rate jumps up a little, a corresponding period of tight money can bring it down again.

That is not the kind of economy we live in now, however. Since the early years of the 1960's, each recession has had less effect of reducing inflation than the previous expansion had in increasing it. The result has been a steady rise in the long-term trend of wages and prices.

The principal reason for this is the fact that wage rate increases have become increasingly less responsive to rising unemployment. In the recession of 1948-49, for example, average wage rates stopped rising altogether when slack in labor markets increased. This year, despite rising unemployment, the rise of average wage rates has not moderated. On the contrary, average wage rates so far in 1980 have been rising about 1 to 1-1/2 percentage points faster than they did in 1979. Moreover, there is relatively little reason for expecting any reduction in the rise of wage rates in the near future. The degree of slack in labor markets does have some effect on the rise of wages, but it takes a painfully long time to work.

In today's economy, any fresh impetus to inflation--whether it comes from rising OPEC prices, a food shortage, a productivity disaster, or a mistake in economic policy--tends to worsen the long-term trend of inflation. Using monetary policy actively as a counter-cyclical device, in the way we once did, is extremely risky because mistakes are inevitable, and they tend to aggravate the long-term inflation problem. This does not mean that the dials of monetary

policy should be set on automatic pilot. It does mean, however, that to have any real hope of ultimately regaining price stability, the principal focus of monetary policy now must at all times be to find and pursue the course of action most likely to bring down the long-term rate of inflation.

The differences in developments affecting financial markets and the real economy that stem from such a course of policy will probably be less evident during periods of recession than during the early phases of economic recovery. Historically, monetary policy has not moved dramatically toward stimulus when the economy headed into recession. Simply holding to a fairly steady course of policy has resulted in substantial declines in interest rates because of weakening credit demands. But during the earlier phase of economic recoveries, growth in supplies of money and credit has often begun to accelerate because the Federal Reserve did not let credit markets tighten sufficiently while unemployment and excess capacity were still relatively high. That is the mistake we must be particularly careful to avoid when the current recession bottoms out and recovery begins again.

Implementing the kind of monetary policy I am espousing will mean, as a general principle, paying more attention to achieving stable growth rates of money and credit than historically has been the case, and permitting interest rates to move sooner, and through wider swings, in response to changes in credit demands. That, as you will recognize, is the basic postulate of the doctrine of monetarism. Mechanical application of that principle, however, could lead to fundamental errors.

The monetarist doctrine is based on the premise that the demand for money is stable and predictable. When that premise holds true, changes in the stock of money exclusively reflect developments on the supply side, that is developments basically controlled by the Federal Reserve. When it does not hold true, however, changes in the stock of money reflect influences from both demand and supply. Money growth is then no longer a reliable guide to monetary policy.

Instead of discussing these issues in the abstract, let me give you a concrete example. During the second half of last year, the narrowly-defined money stock, M-1A, rose at an annual rate of 6-1/4 percent. From the fourth quarter of 1979 through the second quarter of this year, however, growth in this measure of money fell to an annual rate of only 1/2 percent. Some monetarists believe that the Federal Reserve has engaged in massive restraint because growth of M-1A has declined so sharply--restraint that poses the threat of a prolonged and deep recession.

However, there is evidence, and it is in my judgment persuasive, that a sharp reduction occurred in the public's demand for money during the second quarter of 1980--a reduction that cannot be explained by the weakness in economic activity. Estimates by the Federal Reserve Board staff suggest that the reduction in money demand, given income and interest rates, during the second quarter was on the order of 3 to 3-1/2 percent of the money stock.

Put into practical terms, this means that the 1/2 percent annual rate of increase in the actual money stock from the fourth quarter of 1979 to the second quarter of 1980 had the same effect on interest rates--and ultimately on economic activity and prices--as a 6-1/2 to 7 percent rate of increase in money over the same period would have had with a stable money demand function. A prudent and cautious monetary authority cannot, I believe, ignore facts of that kind.

This example is by no means an isolated incident. Beginning around the middle of 1974, the demand for money (M-1A) at given levels of income and interest rates began to decline sharply, according to Board staff estimates, and continued to fall until around the middle of 1977. During those three years, actual money growth proceeded at an annual rate of about 5-1/2 percent. But

the effective growth of money, taking into account the downward shift in money demand, amounted to around 9 percent at an annual rate.

Problems of interpreting money growth will continue to plague us. Next year interpreting changes in the various measures of money commonly in use will be greatly complicated by large-scale entrance of thrift institutions into the checking account business. Growth of M-1A, which excludes NOW accounts and ATS deposits, will be depressed, while growth of M-1B, which includes these accounts, will be accelerated. Efforts will be made to determine the extent to which demands for those two measures of money will be influenced by the growth of NOW accounts; these estimates, however, will at best be very rough. Furthermore, we may have to live with considerable uncertainty regarding the meaning of changes in these measures of money for some time. Mechanical interpretations of money growth in the current environment simply will not do.

Let me turn now to my final point--namely, that monetary policy alone cannot cope effectively with the kind of inflation that is plaguing the U.S. economy and the industrialized economies of the Western World. A prudent monetary policy is a necessary condition for ending inflation. It is not, however, a sufficient condition.

Let me give you a few facts from recent history. In 1977, consumer prices in our country rose about 6-3/4 percent. Two years later, the rise was up to almost 13 percent. What happened to money growth during this period? In fact, it decelerated --M-1A rose 7-3/4 percent in 1977, 7-1/2 percent in 1978, and 5 percent in 1979. Growth of money and prices were not closely correlated during that period. Inflation has its nonmonetary as well as its monetary roots. In periods of several years, or even longer, those nonmonetary forces may predominate.

Almost everyone would agree, I imagine, that the chances of reducing inflation by restraining the growth of money and credit would be greatly diminished if at the same time Federal budgetary policy were highly stimulative. It is also true that the effects of monetary restraint on inflation may be disappointingly small if OPEC is able to increase its prices for oil at will, if productivity declines because of inadequate investment, or if a variety of governmental policies seeking to achieve important economic or social goals do so by raising costs and prices.

Our best hope to turning history around, and bringing the underlying inflation rate down during the next economic expansion, lies in putting the fight against inflation at the forefront of every governmental economic policy decision. The list of things that needs to be done is long and difficult. Let me name just a few.

First, a major objective of Federal budgetary policy over the next five to ten years should be to raise sharply the rate of business investment in new and modern plant and equipment in order to increase supply capabilities and to raise productivity growth. That will require both substantial business tax incentives and greatly increased national savings to finance the needed investment. Greater national savings will be difficult to achieve without more or less continuing surpluses in the Federal budget. Both objectives together will not be realized unless far more effective policies are pursued to restrain growth of Federal spending. Second, policies to decrease our dependence on foreign sources of oil need to be accelerated. We have made great strides in this area in the past several years, but more needs to be done. Third, a substantial overhaul of the financing of social security benefits is needed to reduce sharply the reliance on payroll taxes, which add to business costs and prices. Fourth, substantial further steps must be taken to reduce the effects on costs and prices of governmental regulatory policies--especially policies relating to the environment and to the safety of the workplace. Fifth, a wide range of policies or laws designed to provide income maintenance for particular elements of the economy--such as import restrictions, dairy price supports, the minimum wage, the Davis-Bacon and Service Contract Acts--badly needed to be altered or eliminated altogether to reduce pressures on prices.

If we as a nation did all of these things, and if at the same time the Federal Reserve pursued a steady anti-inflationary course of monetary policy, we could regain price stability during the next decade. Perhaps it would be unrealistic to expect a full measure of success in defeating inflation during the 1980s. We must not fail, however, to take the first essential step--and that is to make some progress in reducing inflation during the next economic expansion. That is the objective to which Federal Reserve policy is strongly committed, and it is the objective on which I will be expending a large part of my energy.

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