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CURRENT MONETARY AND FISCAL DEVELOPMENTS

Remarks of

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The issues and problems of economic policy hold the forefront of discussion and controversy these days. The celebration of the 20th anniversary of the Employment Act of 1946 yesterday marked an important historical milestone. In the past 20 years, we have vastly enlarged our ability to utilize economic knowledge to improve the national welfare. Still it remains most difficult to achieve agreement on, or even a common understanding of, the basic economic decisions that face us.

Controversies exist partly because the subject is so complex. Choice of a proper monetary and fiscal policy is far more difficult than one would gather from catch phrases. There are few simple answers to economic questions. Furthermore, many people are confused as a result of seeming inconsistencies as when economists, having expounded the virtues of a budget deficit, turn around and become the chief supporters of a tax increase to insure a budget surplus. What observers fail to realize is that policy must change constantly as the economic situation changes. What was right yesterday may be disastrously wrong tomorrow.

Economic Relationships are Complex

Life would be much less complicated if the real world were as simple as some believe and if it were possible to determine our course merely by following slogans. For example, our problems would be greatly eased if all that was necessary for proper price and output results was to tighten money and raise interest rates.

Unfortunately, as attested in two recent instances where the simple relationships appear reversed, economic relationships are more complex than that.

In the years 1955 through 1959, the commercial banks were net debtors to the Federal Reserve--a condition that is the simplest indicator of tighter money. From 1960 through 1964, the opposite condition prevailed: banks then had a net excess of reserves. The first period evidenced considerably more monetary constraint than the second. Bank credit and the money supply expanded far more slowly. Fiscal policy was also more restrictive in the first period. The output of the economy did not grow as rapidly as available resources while in the last five years demand moved ahead fast enough to utilize some of the resources previously idle.

From these simple facts what sort of price movement would we expect? Clearly those who stress only the most elementary of relationships would have expected prices to fall from 1955 through 1959 and then to rise from 1960 through 1964 as monetary and fiscal constraint eased. The facts are exactly the opposite. From January 1955 to December 1959, the wholesale industrial price index (probably our best measure of expected monetary impact) shot up at a rate of 2.3 per cent per year. During the next five years, it did not change at all.

The European experience shows a similar failure of agreement with the simple theory. During the past five years most Western European countries have raised their discount rates rather steadily. As a result they have high interest rates. These increased rates have been accompanied by very rapid price increases.

Policies Must Change Over Time

Most modern economics text books open with a chapter emphasizing the idea that policies must change to fit changing conditions. There are no absolutes. Contrary to the impression sometimes given in the press, most modern neo-Keynesian works put as much stress on the causes and ways of fighting inflation as they do on combatting depressions. Depending on the particular relationships of total demand and supply, either condition is equally possible.

As it happened from 1956 to nearly the end of 1965 the problem facing this country was one of fiscal drag and too little total demand. Accordingly, most economists focused attention on the need for choosing public policies to help increase both the public and private demand for goods.

As the economy moved to a higher employment level, however, naturally economists' recommendations reflected a need to change policies to meet the new circumstances. They recognized that demand sometimes may need to be curbed just as in other periods it may need to be fostered.

Causes of Disagreement

Since there is agreement that policy must shift with the underlying economic situation and since there is also agreement in the abstract that there are certain policies that are properly matched with certain problems, what causes all the current controversy over proper monetary and fiscal policy? I think we can find at least three major explanations.

1. There is less unanimity than we think as to the proper goals for our economy.
2. There is uncertainty as to the actual facts that will face us as this year progresses.

3. There is a basic lack of agreement over some of the specific ways in which the economy operates.

Our Economic Goals

All can agree that logical goals for our economy should be maximum growth, full employment, and stable prices. Agreement is even less complicated when the pursuit of these goals promises the simultaneous achievement of balance of payments equilibrium, equal opportunity, free competition, minimum governmental interference, and maximum national security.

Problems arise only when it becomes clear that reaching some of these goals will interfere with the attainment of others. Unfortunately, however, this is the situation. To reach a given level in one sphere may require sacrifices in another. This is a familiar fact of life in both the physical and economic worlds. Since we cannot reach all simultaneously, a great deal of current controversy is actually a debate over priorities among our many desirable goals.

This Year's Economic Situation

Almost always some disagreement exists as to the underlying and prospective economic situations. It becomes particularly acute in periods such as the present when Vietnam expenses, high investment prospects, heavy inventory accumulations, large potential consumer spending are all subject to rather large possible variations.

The President's Economic Report, setting out the Administration's appraisal for the year, stressed that the projections on which it was based were the best possible from the facts available at the end of the year. The Report has not, however, been accepted as a sound basis for

policy by many observers. They point out that the situation may alter. New conditions may arise. They also draw different conclusions from the known facts. Primarily they believe that the probability of unfortunate developments is far higher. They also feel that this is the time to be pessimistic rather than optimistic with respect to the dangers of inflation.

Some of our current debates arise from uncertainties over what the facts and prospects really are. It is hard, however, to distinguish between true disagreements over the facts and those in which differences in philosophies lead analysts to interpret the same facts in opposite manners.

The Functioning of the Economy at High Employment Levels

While the two previous points lead to some controversy, far more of current debate arises from a lack of accord as to how the economy operates near full employment. What are the potential impacts of monetary, fiscal, or other policies at existing economic levels?

All agree that demand should be curtailed when it is so high that additional purchases lead only to price rises rather than to additional output and employment. After vigorous debate, a majority of policy makers agreed that monetary and fiscal policy should help expand demand when employment was at 5 or 6 per cent.

Clearly, however, there is less unanimity now that unemployment is at 4 per cent and heading toward 3.5. What are these disagreements that exist because of differences in analysis rather than from assumptions concerning the current situation?

Wage-Price Guideposts

Some believe that the current levels of high demand give too much power over prices to industry and labor leaders and, therefore, demand should be cut back. They point out that at present levels fewer market constraints exist for wage and price boosts. A small number of key industrial price moves or high wage bargains can set off a rapid upward spiral of prices, costs, and wages. In an attempt to avoid the danger of price increases, these analysts believe that demand should be cut back now so as to return to a considerably higher level of unemployment, less use of resources, and less danger of price and wage movements.

Others are far more concerned with the cost to the economy of the wasted resources that would result from a lower level of demand and output. They feel that with the President's wage-price guideposts, uses of the available stockpiles, and with defense priorities, increased imports, and similar specific steps, we can avoid a wage-price spiral. They trust that when it becomes clear that price restraint or lower production and unemployment are the alternatives, then patriotism and self-interest, plus use of the Government's economic power in specific cases, will reinforce the guidepost policy and will allow the country to utilize a maximum of resources with a minimum of price rise.

Clearly, if present attempts to hold the wage-price line fail, there will be much heavier pressures to reduce demand to a point where market forces will support fewer increases. There will be greater support for those who argue that the alternative policy of lower employment, lower profits, and reduced rate of growth in output should replace the guideposts. The controversies then will revolve around whether demand should

be held down, primarily by aggregate means, or whether selective policies should be introduced to deal with the most troublesome spots.

Contrasts Between Monetary and Fiscal Policy

There is fairly complete agreement that monetary and fiscal policy ought to work together to help maintain demand at a proper level. However, because they work in different ways and affect separate groups, there is less unanimity as to what makes a proper mix in any package.

Monetary policy is far simpler to change. While considerable time was spent in analysis and debate of the discount rate change, once the Federal Reserve decided to move, action was rapid. Within a month of the announcement, the interest rate on Treasury bills and five-year Treasury bonds had risen by nearly half a per cent. In contrast, changes in fiscal policy may take months or even years to vote and implement.

On the other hand, fiscal policy moves alter the level of demand rapidly and measureably. Some impact is felt within the first quarter and a large per cent occurs within the first year. It is rather simple to compute the type and amount of demand shifted.

The amount and type of demand altered by monetary policy is far less certain as is the speed of its effect. While it is agreed that drastic changes in the amount of money have substantial observable impacts leading either to major inflations or depressions, far less is known about what results flow from changes of 2 or 3 per cent in the interest rate or money supply. How much demand will be cut this year as a result of recent changes in monetary policy remains a matter of considerable debate.

When either monetary or fiscal policy is tightened, major complaints are heard from those whose costs are raised or incomes cut. This, of course, is one of the reasons why tax changes take so long. As a rule most people prefer that the incidence of a tax change falls upon the other fellow's income or business. Similarly when interest rates rise, those who pay interest or whose business is diminished by higher rates cry out.

While interest costs exceed interest income for most families, for many the difference is not large. On the other hand, for those who are net creditors, interest tends to be a significant source of income. These contrasts reduce the pressures against tightening monetary policy compared to those against reducing demand through fiscal changes.

The Resulting Controversies

These patent disagreements make it clear why it is so easy to get into heated economic debates at the moment. Some favor more fiscal and monetary restraint because they believe that demand will rise faster than supply later this year. Others want more restraint because they believe demand is already too high. Some fear price rises more than unemployment. Others dislike the guidepost approach to restraining prices and wages more than the alternative channel of restraining them through lowering opportunities for profits and jobs.

Similarly, those concerned with the specific effects of higher interest rates would have preferred to see taxes raised instead. Those who fear their taxes might be raised would like to see public expenditures cut back. Those without jobs would like to see demand rise still further.

It seems clear that under these circumstances the policy maker is going to be loved by few. He has to select an alternative which he feels is possible. He has to balance conflicting goals, and conflicting powers. He has to base policy on what he believes is the most probable economic path even while recognizing that events may alter it. He knows that all he can really hope to do is to improve the likelihood of proper decisions, but he cannot, of course, guarantee 100 per cent accuracy.

At the moment most of the debates over policy concern fiscal and other governmental policies outside the monetary sphere. Temporarily, monetary goals appear less controversial. There is more complete agreement than usual that monetary policy will be expected to decrease the exuberance of the civilian sector. It will also have to reinforce fiscal policy by attempting to see that the demand reduced through the speed-up in tax collections and sale of monetary assets is not re-created through the banking sphere.

Few fear that demand this year will be insufficient to maintain growth and high employment. Our Vietnam requirements as well as the unfilled needs of the Great Society are sufficiently large to make it appear that the problem may be more one of an untoward rather than an insufficient expansion of demand. It is perhaps surprising that in this situation there hasn't been more pressure for tax increases, even if only on a stand-by or discretionary basis, from those concerned over the inflationary possibilities.

The Role of Monetary Policy

Since monetary policy has taken the lead in attempting to restrict demand growth, it is proper to ask how it hopes to accomplish its task. To this question, we find almost as many answers proposed as we find analysts. While work is progressing on finding the precise sequence of effects--i.e., the linkages and timing between policy actions and the actual results, we must admit that uncertainties are still great.

One complicating factor in finding answers is that the Federal Reserve operates in the financial markets whereas the demand that must be constrained is not that for credit instruments, but that for real goods and resources. All that can really be discussed are the most logical possibilities. The primary Federal Reserve action comes through a curtailment of the growth in reserves. As a result the rate of credit expansion must slow down. Firms and households receive lesser additions to their money holdings. Interest rates are higher than they otherwise would be. How much rates rise depends in part upon the long-term expectations of spenders and how much they are willing to pay for more credit. Since credit supplies are limited, a user can obtain more only by bidding it away from others. As in any hoarding situation, the more credit that people put into excess hoards the greater the pressures.

It also is clear that initially the demand which is curtailed must primarily be that for durable goods. Few people pay so much in interest that they have to eat less or cut their use of services as rates rise. On the other hand, a new house, a new plant, a new school, an extra 10 per cent stock of inventories are all undertakings that can be postponed.

Other questions in debate are how the change in financial markets specifically influences purchases of goods and what is the amount of impact.

Some believe that the rise in interest rates forces potential buyers out of the market. They stress that higher interest payments cut builders' profits, raise mortgage payments, increase the cost of bond issues and therefore lead to a lesser willingness to borrow and buy.

Others hold that the impact is felt primarily through the lesser credit availability. Banks lack money to lend and so turn prospective borrowers away or cut the amount they will lend. As a result, the frustrated borrowers must spend less. It is important for all to recognize that for monetary policy to lessen demand, bankers must refuse credit to customers who in other circumstances would be welcomed. To fight inflation in a situation when demand is pressing against supply, credit must be limited, and hopefully the limited supply of loanable funds will be channeled primarily to finance productive expenditures, i.e., those that will increase the current supply of goods. Overly high expectations and inventory building must be held back. Past experience tells us that the loans that do the most damage are those for stockpiling of additional inventories or for building excess capacity of plant and equipment which increase current demand but come on stream too late to add to current supply.

It is hard to pinpoint the exact area of impact of monetary action because the financial mechanism is so complex. There is a high degree of substitutability among types of loans and lending institutions.

Even knowing who gets cut off from credit at a given institution does not tell us who will make the ultimate retrenchment of activities.

In general, indeed, going down item by item or borrower by borrower, may not necessarily give us a good picture of the impact of monetary policy either on total expenditures or on their pattern. The whole may be greater than the apparent sum of its parts. In each case it may look superficially as if no one need be affected. Each type of borrower may appear to have a preferred position with some lenders or some sources of funds. And yet, after all the musical chairs are occupied, someone is left out. Because this process is fluid, who gets left out may be quite different each time. The outcome for each depends on a host of particular factors in the given circumstances. We can hope that lenders will do their best to see that those denied credit are those whose demand is least necessary in the present situation.

The Problems of Plenty

As we listen to the current debates, however, it is useful to reflect on how much more pleasant they are than those of recent years. Five years ago the major debate was over the unsoundness of setting more rapid growth and 4 per cent unemployment as a goal for our economy. People were concerned with the structural changes which seemed to anchor us at higher unemployment levels. They argued against the use of governmental policies to increase the rate of expansion in demand as a means of increasing employment opportunities.

Fortunately, their advice was rejected. We have experienced a record-breaking expansion with the greatest price stability of any

major country. Our chief problem no longer is lack of demand, but the difficulty of dealing with a situation involving Vietnam requirements super-imposed upon an economy which was already approaching a high employment level. This has given rise to exuberant expectations and has meant monetary and fiscal policies have had to shift from encouraging demand to restraining it moderately.

Our problems are simplified because of our recent record growth in capacity and the improvements in technology and productivity. The per cent of capacity required by Vietnam is far less than that for Korea. We have made some progress in programs for retraining and expanding skills. Because the base has grown, a 5 per cent expansion in real output makes far more goods available for our needs than was true even a few years ago.

Because of larger capacity and tighter monetary policy, the planned fiscal restraint this year--even though primarily a one-shot program, to be accomplished in large part by a speed-up in collection of taxes--may turn out to be adequate. The task we face is to slow down the growth in demand in order to match its rate of expansion to that of potential output. If, however, monetary policy fails in its restraint, if the wage-price guideposts don't succeed, or if Vietnam expenses escalate beyond present expectations, then a moderate shift toward fiscal restraint will not suffice. A tax increase will be logical. We will once again have reached that point longed for by many for so long where a large budget surplus makes excellent economic sense.