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MONETARY POLICY

Remarks of

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Member
Board of Governors
of the
Federal Reserve System

at a

Joint Meeting
of the
Boards of Directors
of the
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and its
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I am pleased with this opportunity of addressing such a distinguished group of public and corporate executives. You have asked for my views of the state of our economy--where we are, where we have been, and--far more tentatively--where we might be heading. I hope my remarks may give you some feel for what I see in the present. It should be clear that these are personal observations. I would not even attempt to guess how many of them, if any, would be agreed to by my colleagues.

Most of us are unhappy with the current economic situation. Prices are rising too rapidly. Unemployment is 40 per cent above a year ago. Our real personal income is growing at a slower rate than that to which we have become accustomed. Our individual and collective wants are rising rapidly, but the profits and savings to pay for them lag. We no longer suffer from excess demand, but are not yet certain how rapidly the gap between productive capacity and spending will diminish the rate of price advances and interest rates.

It would be wonderful if it were possible to list a few specific policies that would guarantee a cure for our current malaise. Unfortunately, no simple prescriptions are evident. We are suffering from past excesses. We have no precise way yet of predicting how intense our headache will be nor how long it will last. The unwinding of past speculative binges has frequently been costly to individual firms, persons, and sectors of the economy. The present appears to be no exception to this previous pattern.

But although this situation is not enjoyable, our problems do not seem critical. Progress will continue. Our gross national product will grow. There will be more goods to use. What is not as clear, however, is the rate at which growth will occur, nor how the increase in the market value of goods and services will be reflected in prices, output, and employment. While economic analysis gives conflicting advice, many studies do indicate that further increases in unemployment (even an additional 2 or 3 per cent) would contribute little, if anything, to slowing the rate of inflationary price increases. Since further increases in unemployment will be costly on both general economic and social grounds, great weight should be given to those findings which indicate that unemployment levels are already higher than necessary to fight the inflationary pressures arising from excess demand for labor resources.

There are many who argue that if during this coming year negative factors continue to persist, this should not be a cause for concern by those who shape monetary and fiscal policies. To cure the excesses of the past, the economy must suffer. Such suffering is the price we pay for benefits in the future--perhaps it is also good for our souls.

I don't agree. At any time, proper policies to minimize losses in the economy can be found. We should continue to seek them out. I may admire the courage of my neighbor who prefers to suffer rather than ask a

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doctor to cure his ills, but I don't want to emulate him. If the economy fails to grow at a desirable rate, monetary policy must adjust in an attempt to find a better and even optimum current policy. Even more important is the responsibility of the Federal Reserve to insure that the correction process for individual excesses does not lead to a cumulative contraction of our monetary and credit system. Since this is the basic responsibility of the Fed, as of any central bank, I feel certain it will be lived up to properly.

On the other hand, it would be wrong for me to let anyone assume that I believe that adopting a proper monetary policy will necessarily insure that the economy will follow a desirable, enjoyable, or even satisfactory path. In the first place, monetary policy must be selected in conjunction with fiscal and other policies. Given those other policies, even the best selected and implemented monetary policy may still give unsatisfactory results. Secondly, there are limits to the desirable results we can obtain through influencing the economy's level of spending. There is a range within which fine tuning is impossible. More important perhaps, even if demand in the economy grows at an optimum rate during this coming year, we still may not be pleased. This optimum spending level may well be accompanied by unsatisfactory movements in unemployment, prices, and sectors of the economy. If we desire to minimize such unwanted movements, it may be necessary to adopt policies which deal with costs and supplies. These tend to be less familiar, less popular, and perhaps more expensive.

Our Economic Problems

Most would agree that we are "spending more and enjoying it less." A great deal of this dissatisfaction obviously arises from the fact that we are still at war in Indochina. While the share of our physical resources going into battle has been decreasing, costs remain heavy. The economy suffers from the lagged effects of past as well as current expenditures. Perhaps even more importantly, the war appears to affect the economy with a sense of uncertainty, unease, and a lack of direction.

As in all history, the war has been a basic source of inflationary pressures. Even as it unwinds, its impact continues. Because of its costs, spendable income after allowance for inflation has increased at less than normal rates. Both those who are poorer, and those who only feel so, go forth to battle for a larger share of the economic pie. These attitudes reinforce inflationary pressures.

Public investment in non-military areas has failed to match our wants. The production of housing, expenditures on urban renewal projects, investment in keeping our air and water clean, and funds for new parks and recreation areas have all been insufficient. Consequently, demands in these spheres remain great.

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Since large amounts of military expenditures take place overseas, they have an immediate and unfortunate impact on our balance of payments. We have failed to earn sufficient foreign resources to pay for our needs and desires. This, too, leaves us feeling poorer and distressed as we find we cannot accomplish all we would like to do in the international sphere.

In recent months, moreover, the economy seems to have suffered as much from psychological causes as from real ones. Confidence indexes have dropped sharply. The stock and bond market reaction after Cambodia seems an example of how fighting creates uncertainty in the minds of the average businessman. In turn, most observers believe that the decline in financial net worth is having and will have a direct and negative influence on output and employment.

Particularly deleterious for the economy is the fact that we have moved our economic aspirations from the center stage. We don't have to agree with either Coolidge or our critics of the New Left that "the business of America is business" to recognize that a dynamic economy does require imagination, vision, and careful cultivation both from business and government. As long as the war remains the center of our hopes and anxieties, the domestic sector will suffer.

To the problems of the war, we have added a speculative binge. We now are watching it unwind. In the past few weeks it has become clearer to most of us that so-called "inflationary expectations"--a phrase which in the minds of most businessmen or lenders seemed to carry a not unfavorable connotation for individual decisions--was in many cases simply another term for what in the past was known as "speculative fever."

We have just experienced many of the typical speculative reactions of over-optimism and under-estimating of real risks. It was assumed that every activity whether it was cooking rapidly or buying stocks would continue to grow at a continually faster pace. However, the laws of nature seem once more to have prevailed. We are reminded again, as with Dutch tulips, the South Seas bubble, or Florida land, that a bigger "fool" won't always come along to buy a "story" at still higher prices. The number of stocks whose prices have fallen by 80 or 90 per cent is current proof of this point.

Perhaps more insidious have been the unconscious risks assumed by many sound and well-managed businesses. In a rapidly expanding economy, adequate financial reserves and liquidity seem wasteful. In the same way, umbrellas seem ultra-conservative on every day it does not rain. With a slower rate of expansion, however, normal risks return to be faced by each firm. Traditional reserves no longer seem expensive. Given the fact that

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so many firms of all sorts assumed extra risks, the problem recently has been to make certain that in the course of necessary corrections, sound businesses don't go down the drain with poor ones. Most major crises of the past have occurred when basically credit worthy firms went bust as confidence was shattered.

The Federal Reserve has tried in recent months to make certain that sufficient credit exists for all normal business situations. We have acted and clearly must continue to do all in our power to limit any possibilities of a cumulative contraction. As past excesses are unwound those who went far beyond the limits of normal prudence may perhaps suffer but we should minimize the suffering of the innocent. (As an aside, I might note that this has been possible without a policy which some have characterized as "one of very rapid monetary expansion." In fact, I shortly expect to hear complaints about the failure of the Fed to expand money rapidly enough from those who follow the practice of using completely arbitrary bases in their analysis of monetary policy. Perhaps the need for these analysts once again to change views so rapidly may lead to a more careful use of the basic tools of economic and statistical analysis. This would allow statements to gain some credibility as being based on facts rather than figments of statistical imagination.)

Our Policy Tools

Many people in recent weeks have raised questions as to whether the tools of economic policy are working as they should or whether they contain basic flaws. I think in this debate, there have been some failures to recognize that over-all macro monetary and fiscal policies primarily influence total spending and not individual demands, outputs, or prices. Furthermore, the actual spending total at any given time will vary somewhat from hoped-for or desired levels because of chance and random events and because there is a minimum range of variance or "noise" in our economic measurements.

We have no accepted estimates of the range or variance that can be expected around our policy goals. Sometimes when talking about GNP the range of plus and minus five billion dollars annually is used. This was probably too small even when this range was introduced. Since it is now a much smaller part of an expanded GNP, it is doubly suspect. Yet the exact point within this uncontrollable margin at which the economy ends may well mean the difference between an outcome we consider satisfactory and one that may be characterized as inflationary or recessionary.

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I just checked our estimates made a year ago of where our economy would be at this time. In terms of GNP or total spending, the outcomes were amazingly--nay, embarrassingly--good. If I did not know better, I might believe the Fed had an overwhelming influence on total spending and thus was able to insure the accuracy of our forecasts. We were off by only about $3 billion out of a GNP of nearly a trillion. The error was only 3/10's of a per cent and even in terms of predicting the much smaller growth in spending, the difference was well under 10 per cent.

Unfortunately, however, this accuracy did not hold for estimates of prices, real output, and unemployment. The GNP total contained offsetting misses. Actually, prices grew about 1.4 per cent faster than predicted and real output lagged by nearly that amount. In terms of change, these errors were about 25 per cent. A roughly similar error applied to the changes in unemployment also.

When I look ahead, it seems to me that many of the problems we have been facing will continue, and that macro policy actions may not be able to cope with them in a fully effective manner.

--- An attempt to meet head-on the possibly unsatisfactory spending outcomes must face the lack of short-term flexibility in many of our economic policy tools. We have been sensitized (perhaps too much so) to the inability to turn policy around rapidly. Current decisions must be concerned not only with the spending level for this year, but also for that of the year or two beyond. The greater the weight given to this fact, the less flexibility there is in solving this year's problems.

--- Furthermore, when I look at past relationships and ask what the unemployment and price effects of a given spending change are likely to be this year, I find logical estimates that vary all over the map. When I feel optimistic, I can foresee both unemployment and prices rising less than this past six months. On the other hand, I can just as easily find estimates for this fiscal year of price and unemployment rises far beyond those most of us would consider reasonable.

--- The fact that the policies we have depended on in the past primarily affect total spending and not its components may cause even more dissatisfaction in a period such as the present. Even with fairly rapid growth and expenditures of over a trillion dollars, many may be unhappy. They may not like the trade-off between price movements, output, and employment. They may feel the share going to housing, state and local facilities, recreation, etc., is too small. Results in individual sectors are, moreover,

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only indirectly influenced by our current macro policies. If the individual sector levels obtained with general monetary and fiscal policy are unsatisfactory, better relationships must be sought through the use of other types of policy tools.

Even if many are dissatisfied with current economic achievements, existing policies may not be able to guarantee any better results. Our economy may well be operating within as narrow a range as can be expected, given the types of policy tools now in use. To narrow our price-output range further, we would have to try policies of finer tuning, or ones which attempt to influence the demand side in more detail, or ones that would deal directly with the supply of goods and labor.

Without more aggressive attacks on individual prices and restrictions, on shortages, or on bottlenecks in supplies, through active incomes policies or similar approaches, we are primarily crossing our fingers and hoping that the projected level of demand will give a desirable price-employment relationship. Unless our luck is extremely good, the new Commission on Productivity will have a major role to play in determining this next year's results.

This Coming Year

The problem of cleaning up after the excesses of the past few years is what makes the forecasts for this coming year more liable to error than normal.

According to past relationships, the economy should be producing considerably more real goods by the end of the year than it is now. Thereafter, output should accelerate. Jobs should increase. But since the labor force is growing this does not mean there will be fewer unemployed. The fact that our economy is producing at less than its full potential should lead to a slowdown in the rate of price increase, but how long it will take to return to reasonable price stability is unclear.

It is important to note, however, the conflict among economic studies on the relationship between unemployed labor and price stability. Some show deflationary pressures directly related to the level of unemployment. Others with equal analytical and statistical authority show that unemployment already is higher than necessary for the labor excess to exert almost its maximum deflationary pressure. These show that more unemployment will not act any faster than current levels to slow price increases. Since further unemployment is obviously costly both to the individual involved and the nation as a whole, this indicates to me that unless these studies are found to be incorrect, we should want a spending level that does not raise unemployment above current figures. In fact some fall in unemployment would be preferable.

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The problem with making projections today is that we don't know how shaken the average person and businessman is by the shocks of war news, the stock market decline, and the recognition that all risks have not disappeared from the economy. The type of spending slowdown we are now in has not, in any postwar period, led to a major shift in spending decisions. After a pause for inventory corrections, the economy has continued to expand. Should we expect the same results this time? No one feels certain of the answer. The critical areas to watch are expenditures on plant and equipment, inventories, and consumer goods. So far, all of these have followed close to the paths expected. If one or more of these indicators strays below the expected path, however, it is hard to point to others which will spend above their normal levels to offset these losses.

Whatever the individual decision-makers decide, a major challenge for all of us in the Federal Reserve System is to make certain that any shifts in spending or in credit do not become cumulative. The Federal Reserve System was established to make certain that our credit system remained elastic in order to avoid the crises and panics of previous decades. While our pre-World War II record was far from perfect, I do believe that we now have the experience and the knowhow to stand up to our responsibilities. Without a cumulative credit contraction, it is difficult to plot a scenario that would include a major depression.

This fact contains both a critical lesson from history and a major challenge for the present. I hope and believe that it is a challenge that the Federal Reserve can meet without much difficulty.

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