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CHARTING THE COURSE OF ECONOMIC POLICY

Remarks of

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Charting the Course of Economic Policy

As one of the principal instruments of national economic policy, the conduct of our monetary affairs plays an important role in shaping the behavior of the United States economy, both in the short run and over the longer sweep of time. If the Federal Reserve makes possible the provision of too much money and credit, the result will be to exacerbate the inflationary tendencies already all too evident in our economic performance. If, on the other hand, too little money is created, the effect will be to restrict unduly the public's purchasing power and to risk an inadequate generation of demands compared with our capacity to produce goods and services; the outcome, in this case, may be a disappointing rate of growth and, perhaps, economic recession.

Any such simple theoretical statement of the power of monetary policy, however, grossly exaggerates the range of options that policy-makers have. As a practical matter, it usually seems to me that the position we must take is "in between." We find ourselves in between those who would urge maximum economic stimulation, so that material progress would be achieved and more jobs created for the unemployed, and those who would urge that purchasing power be limited, so that inflation may be discouraged and eventually brought under control. We find ourselves in between those who would advocate stabilizing or reducing interest rates, so that the cost of credit would not add its bit to the inflationary burden, and those who believe we must limit and gradually reduce growth in the monetary aggregates, which provides more fundamentally the fuel for continued inflation. And we stand in between those who would emphasize short-run economic performance, even at the risk of building problems for the future, as versus those who advocate seeking always the best conditions for balanced longer-term economic growth, even though this might mean a less robust short-run outcome.

My point in outlining these opposing views is not to seek sympathy for the policymaker's plight, but rather to dramatize the very real and fundamental economic choices involved. Each position has a sizeable body of adherents and each is argued forcefully from time to time in one public forum or another. Moreover, each approach has some economic logic behind it and represents a point of view that needs to be taken carefully into consideration. It is not surprising, therefore, that in a democratic society the policy options adopted tend to be compromises. We cannot afford to focus single-mindedly on one economic objective, no matter how desirable its achievement might be, when the society has multiple goals. Instead, it is my observation that the only real choice policymakers generally have is to seek a reasonable balance between employment and inflation objectives, between interest rate and monetary growth considerations, and between short-run and longer-term economic performance. The result may well be the optimal one that can be achieved under the circumstances, taking into account the whole range of economic objectives to be served, but by its very nature it will not be fully satisfying to anyone.

Another aspect of national economic policy that I would like to emphasize is that policy choices can only exert a degree of influence on the performance of the economy--they cannot determine the outcome. This may seem an obvious truism, but I think that there has been a strong tendency in recent years to exaggerate the cause and effect relationship between actions in Washington and developments in the economy. Policymakers cannot determine the weather, or offset the effects of a crop failure, or mandate the decisions of economic power groups--whether they be coal miners or the cartel of oil exporting countries. And the public's response to policy actions can be quite variable, depending as it does on the state of confidence, perceptions as to the desirability of the actions, and rational expectations as to the probable effects. In the case of monetary policy, for example, we have found that the linkages between our actions and their economic effects are a good deal looser than we used to believe. A smaller increase in the money supply can sometimes be associated with stronger expenditures, if people are becoming more confident, while a larger increase may bring a less than proportionate rise in spending, if people become more fearful of inflation and future prospects.

We spend a great deal of effort at the Federal Reserve, therefore, on detailed analysis of the current economic situation and near-term outlook. Information from many independent sources is gathered and considered, including the use of econometric models, the analysis of all the various statistical series on financial and nonfinancial developments, and a careful monitoring of the comments and views of the Federal Reserve

Bank directors and business and community leaders such as are represented here today. This close attention to the immediate situation is all to the good, since it is the economic environment of the time that will primarily determine the monetary policy actions to be taken and the setting of near-term objectives for economic performance that are practicable and seem achievable. At present, our analysis would indicate that conditions are relatively favorable, once we can shake the temporary effects of unusually bad winter weather over most of the country and assuming that the difficult coal strike problem can be resolved before serious economic damage is done. Real growth in the economy should continue this year, albeit at a moderate pace, and the problem of inflation--though remaining very serious--hopefully will not become more acute.

Admittedly, these prospects are not particularly satisfying in terms of making good progress toward the nation's twin longer-term goals of full employment with reasonable price stability. Even after another full year of moderate economic growth, the unemployment rate is likely to remain significantly higher than we had become accustomed to earlier in the postwar period. And even if inflation does not intensify, the basic inflation rate of the past couple of years--one of around 6--6-1/2 per cent--is likely to persist. The fact is that both unemployment and inflation are very difficult, stubborn problems, and that they will require a great deal of work over a long period of time to correct. The solution, moreover, requires not just the intelligent use of fiscal and monetary policies, but also the development of specific programs directed to the particular structural problems that confront us.

Some of our present difficulties in achieving a good economic performance stem, no doubt, from inappropriate past public policies. The minimum wage laws, for example, have the effect of denying employment opportunities to teenagers possessing only limited skills, while some of the rulings of the Federal regulatory commissions serve to constrain competition and raise average prices. But a sizeable share of the problems, I believe, have their roots in very long-term changes in the characteristics of our economy and the behavorial responses of our citizens. Since these changes are so gradual, their influence is often overlooked in the continuous evaluations and reevaluations of the current economic scene. But they are occurring, and their influence can be profound. There is undoubtedly a long list of such trends, of varying degrees of importance. But I have gradually become aware of four major developments--ground swells, so to speak--that I believe to have importantly conditioned our economic environment and will continue to do so for many years to come.

First, I would note the increasing threat of recurrent materials shortages as world economies continue to expand. The leading example currently, of course, is energy. For the moment, there may be a physical surplus, as I understand is the case on the West Coast. But with demand having grown for many years at rates well in excess of newly discovered supply, it seems clear that the restricted availability of usable energy resources will become a serious constraint on the character and extent of future economic expansion. At the least, we are subject to sharp increases in energy prices, which will importantly influence decisions as to the factor inputs in the production process and the location of new facilities with respect to supplies and markets. The need to begin to alter our ways is clearly recognized in the current push for energy legislation.

Probable energy shortages, however, are only the most dramatic example. There are other potential supply problems that could bring unexpected economic shocks in the period ahead. Food is now in relatively ample supply, following several years of favorable growing conditions. But we cannot count on continued good crop years, and it is instructive to remember that the World Food Conference was convened in Rome on an emergency basis as recently as the fall of 1974. Limited availability of other materials--copper, bauxite, nitrates, paper pulp--has threatened in the past, and probably will do so again, especially with growing world demands and the recent shortfall in new investment. The effect of unexpected shortages, it should be remembered, is almost always to push up sharply the prices of the commodities in short supply. This, in turn, tends to set in train compensating adjustments of an inflationary character, as we learned in the 1973-74 episode of double-digit inflation.

The second profound change I would bring to your attention is the major shift that has been taking place in our population mix. Since 1960, the birth rate in the United States has dropped 40 per cent in relation to the total population, and there has been a 52 per cent drop in average family size for women of child-bearing age. This unprecedented decline, I believe, has already had vast implications for our economy. It has brought not only a relative, but in some instances an absolute, decline in the child-oriented market for goods and services, including schools, some hospital facilities, and the size and character of housing market demands. It has freed many women to look for employment opportunities outside the home, so that the proportion of adult women (ages 25-54) in the labor force has grown from just 40 per cent as recently as 1955 to 60 per cent currently. And it will in time be adding to the real cost of supporting the elderly, as the proportion of people 65 and over grows from 10 per cent of the population in 1960 to 11 per cent in 1980, and a projected 12 per cent in 1990.

It seems to me that some of our policy problems have been, and will continue to be, aggravated by these population trends. As more women have actively sought work, for example, the economy has needed to generate more and more jobs in order to keep the unemployment rate down. Because of the change in market orientation, moreover, some skills (such as teachers) are in oversupply. And the cost of providing benefits to the rapidly rising numbers of retired workers was, of course, a significant consideration in the revamping of the Social Security system this past year.

A third major trend that cannot be considered an unmixed blessing is the continuing shift in population to the sunbelt--broadly defined as the West and the South. For the United States as a whole, population growth from 1970 to 1976 totalled 11-1/2 million, of which all but 1-1/2 million was located in the Western and Southern states. For the 1970-75 period, aside from the natural increase (births minus deaths), there was an actual outmigration from the North--a broad band of states that still account for fully one-half of our total population.

This movement to the sunbelt appears to have slowed in the mid-1970's, perhaps reflecting economic conditions, but I can see no basis for expecting that the trend will not reassert itself and perhaps intensify. The rising cost and uncertainty with respect to future energy supplies is a new factor among many tending to encourage this relocation.

The shift in population represents an important economic opportunity for the growing regions, but it also imposes substantial costs on both the developing and the mature areas of the country. For the developing regions, the necessary economic infrastructure--roads, schools, water, power--must be provided, and the cost and difficulty of maintaining environmental standards is heightened. For the mature areas, the same infrastructure tends to become underutilized. Costs continue to go up in part because of the characteristics of those left behind, and the economic tax base tends to level off or contract, adding to financing problems. In general, of course, there is a more bullish tone to the discussions of prospects for those in the sunbelt. In meetings with Federal Reserve Bank directors from around the country, I have noted in recent years a pronounced difference in comments about economic conditions that appears to be directly correlated with geographic location.

The fourth and final trend that I want to bring to your attention is the intensification that has occurred in inflationary bias. In nearly 30 years as a practicing economist, this seems to me to have been the most persistent trend of the postwar period. It used to be said that our economy tended to generate higher price levels over time because there was a ratchet effect--prices rose during economic booms but resisted decline during recessions.

Later it was thought that inflation at a 2 - 3 per cent rate could hardly be resisted, because of changes in income distribution and the tendency of wages to rise with past price increases as well as productivity. Now, as I stated earlier, the basic inflation rate is generally regarded as being in the 6--6-1/2 per cent area, with little or no sign of moderation. I would note also that the problem is not ours alone--higher inflation rates have emerged and continue as major threats in virtually all developed economies.

What accounts for this ominous and persistent trend? The cycling upward of wages and prices--where wages rise to reflect past price increases and thereby force new price increases--is a major element in the problem. With compensation rising at about 8-1/2 per cent per year and productivity at about 2-1/2 per cent, the resulting 6 per cent increase in unit labor costs simply must be reflected in the price structure.

In addition, it seems to me that almost all institutional arrangements in the economy are geared to inflationary solutions to income distribution problems. Thus, minimum wage laws are escalated to keep pace with inflation, Social Security and some other retirement benefits are indexed to the cost of living, and public employees are given comparability increases without regard to productivity or value of output. Business policies, labor contract bargaining, and government programs are all set in terms of augmenting money income to maintain purchasing power, rather than attempting to achieve similar results in real terms by reducing costs and hence, price pressures. In part, too, the problem is social as well as economic. With better communications and rising material aspirations, all sectors of the economy have become less and less willing to lag behind in the income parade. This means, as a simple arithmetic proposition, that the lower end of the frequency distribution of income gains is cut off, so that the average increase is raised. In short, losers from inflation tend increasingly to be protected, while those who profit--except for taxation--keep their gains. The result must necessarily be a more inflationary outcome for the economy as a whole.

From what I have said, it must be evident that I believe inflation has become our major long-run economic problem. Not only is the inflationary bias stronger than before, but the other long-term trends that I have noted contain important inflationary ramifications. Moreover, I believe that the evidence indicates this to be the situation not only in the United States, but throughout the modern industrial world.

The question remains as to what macroeconomic policy, including monetary policy, can do to help correct our inflationary condition? It seems obvious to me that policymakers must give very important weight to resisting any step-up in inflationary pressures. The threat that this could occur is pervasive, and with a public that is now sensitized to inflation, any significant and sustained step-up in price pressures would surely lead to decisions--and defenses--that could be seriously destabilizing. In this environment, it is particularly important that monetary policy avoid providing excessive financial liquidity which could be used later on to fund inflationary increases in demand.