

FOR RELEASE ON DELIVERY
FRIDAY, MARCH 7, 1980
9:30 A.M. PST (12:30 P.M. EST)

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Remarks by

Henry C. Wallich
Member, Board of Governors of the Federal Reserve System

at a meeting sponsored by the

Federal Reserve Bank of San Francisco
and the
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I appreciate the opportunity, provided by the American Bankers Association and the Federal Reserve Bank of San Francisco, to review with you the functioning of monetary policy in our economy. To introduce the topic, to which the three panelists will also address themselves, I shall say a few words about the environment of accelerating inflation in which Federal Reserve policy has evolved over the last few years. I shall then discuss the way in which I see monetary policy operating and conclude with comments on how I believe we should proceed hereafter.

The Policy Environment Since 1975

Since early 1975, the American economy has been recovering from the most severe recession of the postwar period. Unemployment had risen to a peak of 9.0 percent in May 1975. Inflation had risen to a peak of 12.2 percent in 1974 and during 1975 dropped to 7.0 percent. Over the

following years, the Federal Reserve was deeply concerned both about unemployment and inflation, seeking to contribute to reducing the first and to reducing further the second.

During 1975 and all following years, and indeed since 1970, the Federal Reserve sought to implement these policies by controlling the growth in the money supply. Repeated statements by Chairmen Burns, Miller and Volcker indicated a recognition that the money-supply targets presented to the Congress from time to time would have to be reduced progressively if inflation was to be brought down. Five years after the last recession, we find ourselves with an unemployment rate of about 6 percent and an inflation rate, as measured by the consumer price index during 1979, of over 13 percent. In 1980 so far there are signs of further acceleration.

Federal Reserve policy, of course, is only one factor among several that influence economic conditions. Fiscal policy, and numerous legislative, regulatory, and administrative policies of the government also play an important role. Crop failures and the enormous rise in oil prices have contributed to our problems. Thus our injuries are not entirely self-inflicted.

Nevertheless we must recognize that Federal Reserve policy has had to be made in an environment in which, until very recently, predominant emphasis was placed on expansion. I shall quote only one statement among many that illustrates my point. The Joint Economic Committee, in its midyear 1977 review of the economy, dated September 26, 1977, said: (page 4) "The view that inflation must be stopped at all costs -- including the cost of higher unemployment and slower growth -- is firmly rejected as primitive

and ineffective." In addition, the Committee stated (page 78): "The obsession with inflation has caused the Fed to reduce real M-1 by about 9 percent since the end of 1972. This disastrous policy was a principal cause of the magnitude of the recession; has been a perennial source of obstruction to recovery, and it now threatens to abort the recovery entirely if the policy is continued." Critics who today find that the Fed has been too easy did not necessarily hold that view while those policies were being enacted.

Furthermore, since mid-1978, or even earlier, Federal Reserve policy has been made in an environment of anticipated recession. The Blue-Chip Economic Indicators, a widely read summary of numerous forecasts, developed a consensus on a mild recession to occur in 1979 in December 1978, after a growing minority of forecasters had been predicting recession well before that date. The Federal Open Market Committee received forecasts from its staff of a recession beginning July 1979, with concerns about possible recession expressed by members of the FOMC going back to late 1978. I should add that I have accepted recession forecasts for 1979 or 1980 at face value, while believing that the associated inflation forecasts were unduly optimistic. But although some of my friends seem to regard me as somewhat conservative, I have to blame myself today for not holding out frequently enough for a harder policy. Thus, concern with overcoming the unemployment effects of the 1974-75 recession may have tended to merge unperceptively into concern with preventing a recession in 1979 or 1980, even though inflation always ranked at the top of Federal Reserve concerns.

Monetary Policy at Work

Under these circumstances, monetary policy never seems to have focused adequately on the capacity squeeze developing in the latter stages of the expansion. During 1978, unemployment dropped from about 7 percent to about 6 percent, and capacity utilization rates rose from 82 to about 87. Thus, at the beginning of 1978, there seemed to be plenty of slack in the economy, by past standards. Today it is evident that our economy is so shot through with inflexibilities and distortions that pressures upon capacity develop at much lower levels. Some analysts now see supply constraints developing at 6.5 percent unemployment. In 1978 it was high time for fiscal and monetary policy to start aiming at a soft landing. There are central banks in the world that have the foresightedness, and the courage, to "take away the punch bowl when the party is getting good." It is clear from our experience that that was what needed to be done. I need not try to conjure up for you the reaction that would have eventuated had the Federal Reserve tried to do this in 1978.

For historical reasons, our country is extremely sensitive to recession and unemployment. We have suffered severely from unemployment, we have never suffered severely from inflation, and we probably never shall suffer from inflation, as some foreign countries have, by a total wiping out of our money and savings. But that does not mean that inflation is not costly. It demolishes our productivity and tears at our social fabric. Over time, the cost of accepting inflation is sure to be higher than even the horrendous costs attributed to stamping it out, which I believe are greatly exaggerated.

Because the costs of inflation accrue over time and in any event are not directly observable, we continue to be sensitive to recession even when more careful analysis should dissuade us. Why is it that a drop in real growth from 6 percent to 1 percent is accepted with relative equanimity, but the prospect of a drop from 1 percent to -1 percent arouses hysteria because it is "a recession"? Why do we focus so intensely on the result of statistically averaging the obvious recession conditions in Detroit with the very strong expansion on the West Coast and in Texas? Indeed, what is the meaning of an unemployment figure of 6 percent that is an average of unemployment of married males (16 and over) of 3.4 percent and teenagers of 16.3 percent?

Through long training and exposure to professional criticism, the Federal Reserve is extremely sensitive to the risk of overstaying the cyclical peaks and troughs, even if these cycles have turned out to be very moderate. But continuous switches from ease to tightness and back to ease have helped to bring us where we are. We need a steadier policy.

Guides to the Future

While the inflation lasts, the Federal Reserve should be focusing on the one objective of bringing it down. Unemployment should be dealt with by other means than overheating the economy. There are many constructive ways of doing that, from job training to hard-core hiring subsidies to improvements in literacy, and, where necessary, improvements in unemployment compensation for those who demonstrably cannot find work. So long as we have not even exempted teenagers from the minimum wage requirements, we can hardly say that we have made a thorough effort to deal with unemployment by micro policies.

The Federal Reserve would not cease to be making a contribution to removing unemployment. But it would be doing so by reducing inflation which is one of the causes of lasting unemployment, rather than by the short-lived device of monetary expansion.

Even if the Federal Reserve focuses exclusively and steadily on inflation, it will have a long job before it. I believe that the prescription, often endorsed by the Federal Reserve, of bringing down the rate of growth of monetary aggregates gradually, is the right one. I do not believe that the "cold turkey" approach is right, although the gradualism practiced in the past certainly needs to be speeded up. Gradualism must not come to mean putting inflation fighting on the back burner. Because the process takes a long time, it must begin right now. This policy should be accompanied by a broad-based attack on inflation through fiscal restraint, and elimination of the myriad price-raising actions and regulations of the government. I do not believe that mandating a balanced budget is meaningful, since we could not stick to such a mandate in a recession. But we should control the share of the government in the economy, and slow down the rate of growth of government spending. In my view, we should also adopt an incomes policy based on the tax system (TIP).

By setting money-supply targets that are well below the rates of monetary growth that prevailed in 1979, and by redefining our monetary aggregates so as to encompass forms of money, including Eurodollars, that in the past have escaped us, I believe that the Federal Reserve has put itself on the right track. I would like to conclude by commenting on how this control of the money supply affects the economy. We do not have some

black box where money goes in and GNP or the rate of inflation comes out. The process works quite understandably through interest rates. Letting the market set interest rates, through the interaction of the demand for money and credit and a relatively stable supply, has an advantage. No one can tell what interest rates are appropriate in an inflation, and letting the money supply do the job protects somewhat against the temptation of always doing too little and too late.

Interest Rates During Inflation

Our experience with inflation, as well as that of other countries, seems to show that interest rates broadly seem to move with the level of inflation, the "real interest rate," that is, the interest rate adjusted for inflation, seems to have a tendency of remaining roughly constant, sometimes slightly negative, sometimes slightly positive. A tax-exempt investor under such conditions might barely preserve his principal.

Unfortunately, the impact on borrowers of interest rates approximately equal to the rate of inflation is very uneven. For an individual borrower using the standard deduction in his tax return, today's rates may have considerable bite. For a construction firm that cannot use the deduction because of losses, the bite may be severe. For the wealthy New Yorker with a 70 percent top bracket rate, a New York State rate of 14 percent, and a New York City rate of 4.3 percent, the bite is minimal. For a corporation paying 46 percent tax, the bite at any rate is almost cut in half.

Inflation, however, endows tax deductibility of interest with an additional kicker. The borrower deducts not only the real interest he pays, but also the inflation premium. That premium matches, more or less, the

reduction in the real value of his debt that comes from inflation. In other words, the inflation premium is a form of debt amortization. The tax law, of course, never intended amortization to be deductible. Inflation however, makes it so. This unintended subsidy to borrowing mounts as inflation and the nominal interest rate mount. The consequences of that we can see all around us.

I say "around us" advisedly because we are here in San Francisco. Unfortunately, I cannot report to you that this is perceived at all clearly either in all academic or all policy-making circles. Many critics of high interest rates argue as if today's nominal interest rates were real and as if we were still in the days of the 4 percent mortgage and the 2-1/2 percent government bond. Economists refer to this as "interest illusion," analogous to the "money illusion" under which some people believe that a dollar yesterday equals a dollar today equals a dollar tomorrow. Money illusion seems to have been dispelled pretty thoroughly for most people. But so long as interest illusion persists among lending analysts, it will be difficult to maintain realistic monetary policies, even though the other 220 million around the country act as if they had shed their illusion very thoroughly.

In the past, monetary policy could be made to bite without very high interest rates because it could rely on availability effects. When mortgage funds were disintermediated out of the thrift institutions, when bankers, fearing real tightness, cut back on their customers' loan demands, it was availability rather than cost that made restraint effective. Today, we have shielded the housing industry, and in one sense at least the thrift

institutions, by helping the market to knock breaches into Reg Q. Bank credit has been freely available, although at a high nominal price. If price rather than availability has to do the job, it is clear that interest rates have had to be higher than they would otherwise have been in order to ration demand.

The ensuing wider range of interest rates is enhanced by the fact that much lending is on a floating-rate basis, so that the high cost is perceived as quite possibly temporary. I do not by any means underestimate the pressures that high nominal interest rates can produce, even if, in real terms and after taxes (after taxes and inflation), they are negative for most borrowers.

The answer is that we do not have good options. If it were easy and painless to bring inflation down, one would think that we would already have done the job. But I see no alternative to biting the bullet and taking our medicine now unless we want to repeat the experience at still higher levels of inflation and interest rates.

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