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OBJECTIVES IN CONFLICT:
STABILIZATION POLICIES AND NATIONAL PRIORITIES

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By
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With the passage of each week, the fundamental conflict between the campaign to bring inflation to a halt and the pursuit of other national goals is becoming sharper. Unfortunately, the basic incompatibility of some of our objectives is frequently obscured by narrow technical arguments over the conduct of monetary and fiscal policy, by different views on the Vietnam War, or by ideological differences about the appropriate role of the Federal Government in the life of the nation. While a primary aim of national economic policy is to check the current inflation in the United States, another objective -- of almost equal importance -- is to avoid massive unemployment and the aggravation of the urban crisis. While a significant share of our resources is devoted to the Vietnam War effort, the private demand for goods and services (especially that arising from the business sector) is also expanding more rapidly than our ability to meet such demands. Although the prospect is for a return to a serious deficit in our international balance of payments, some observers are urging that restraints on the outflow of U.S. capital be dropped immediately.

Still other evidence of conflicting objectives could be cited, but such a listing would simply lead to the same conclusion: we face an

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almost desperate need to sharpen our priorities and to rearrange our instruments of public policy to accomplish more efficiently our most pressing goals.

Since each one of us undoubtedly will have his own conception of the proper objectives and conduct of public policy, it may be well for me to spell out promptly the perspective from which I view the current tasks of national stabilization policies:

- For nearly four years now, since the acceleration of military activity in Vietnam in mid-1965, we have been fighting a sizable war without raising sufficient tax revenues to finance it. In fact, the Federal budget deficit as a percentage of the increase in Vietnam War -- related outlays has been almost as large as in the First and Second World Wars -- and in sharp contrast to the budget surplus achieved during the Korean conflict.
- Consequently, while the Federal Government's claims on the nation's resources have risen substantially since 1964, private claims have also been allowed to increase roughly in line with the growth of real output. The results have been a drastic rise in excess demands placed on the economy, an intensification of inflation, and growing expectations of further inflation.
- Although monetary and fiscal policies have attempted to counter the emerging inflationary pressures, the timing, scope and coordination of the measures adopted have been far from ideal. Thus, their impact on the pace of inflation has been only modest and temporary, and they have done virtually nothing to weaken inflationary expectations.

Under these circumstances, I am personally convinced that the most important assignment for national economic policy is to get on with the task of bringing inflation to a halt. I think this objective should

take priority over some of our other important goals -- such as minimizing the rate of unemployment or optimum funding of programs to aid the cities. In reaching this conclusion, I am not unmindful of the pressing need to cope with the crises in our urban areas and to foster the improvement of our human resources. Rather, I believe that even these critical objectives cannot be reached without the attainment and maintenance of a high and stable rate of growth in real output in the long-run. In turn, a precondition for the emergence of such a pattern of growth is an early end to the current inflation.

However, I also realize that, because inflation has been allowed to become so firmly embedded in the structure of the economy, perseverance will be required for perhaps a year or more to halt inflation completely without bringing about a drastic decline in output and a dramatic rise in unemployment, neither of which is acceptable to the vast majority of the American public. On the other hand, there is no reason whatsoever to believe that even a modest lessening of inflationary pressures can be achieved without a significant slowing in the rate of economic expansion and some increase in unemployment. The critical question is where to strike a balance between these competing objectives. In my view, the principal weight should be placed on the side of checking inflation, and we should be prepared to accept the unfavorable effects on output and employment as part of the cost of attaining this goal.

At the same time, however, I believe we should be equally concerned about where the real burden of fighting inflation actually

falls. It should not fall exclusively on the poor and the disadvantaged nor primarily on particularly vulnerable sectors of the economy. Yet, without careful orchestration of stabilization policy instruments, that is exactly what we should expect to happen. For example, primary reliance on monetary policy would undoubtedly mean exceptionally high interest rates, serious disruptions in the functioning of money and capital markets, and drastic declines in the availability of credit to specific sectors of the economy -- while other sectors continue with little, if any -- changes in their credit-financed spending. On the other hand, primary dependence on fiscal restraint achieved through a drastic curtailment of nondefense Federal expenditures would shift an excessive share of the burden to urban areas and to the poor and the disadvantaged who must rely substantially on such assistance if they are to make headway toward leading meaningful and productive lives.

These considerations lead me to the conclusion that the best way to press the campaign against the current inflation in the United States is to re-cast our national priorities and to re-order the claims on our national resources. To be specific, I believe that we should pursue the following course.

- We should seek a sizable surplus in the Federal budget during the next fiscal year, but we should also expand outlays for urban and human resource development. To achieve these ends, we should reduce other types of Federal expenditures -- including military outlays wherever possible.

- Despite these economies -- and to guarantee a sizable budget surplus -- it is clear that the 10 per cent income surtax should be extended. In fact, in view of the sharp rise in business fixed investment projected for this year, it seems unwise to consider reducing the rate.
- To reinforce these fiscal moves, monetary policy should maintain a posture of substantial restraint. Moreover, such a policy should be sufficiently restrictive -- and held long enough -- to ensure that the rate of expansion of bank credit will be kept quite modest until real progress has been made in checking inflation.

In my opinion, the strategy of stabilization policies sketched above is far preferable to several alternatives which are being urged -- some openly, others more quietly. For example:

- Increasingly, it is being suggested that the Federal Reserve System encourage the adoption of a voluntary program under which banks and other lenders can agree on credit rationing among different types of borrowers.
- Suggestions are also being heard that direct controls over wages and prices should be adopted.
- Finally, more and more, arguments are being advanced which hold that we really cannot afford to pursue vigorous anti-inflationary policies because such efforts -- if successful -- would generate serious disorders in our cities. Thus, the only alternative is to accept the inflation.

In my personal view, these alternatives should be rejected without hesitation. In the closing sections of these remarks, I explain why.

War Finance and Inflation

As mentioned above, the chief cause of the current inflation can be identified easily: it has arisen primarily from the deficit financing associated with the Vietnam War. Almost four years have passed since military activity in Vietnam was accelerated in the summer of 1965. But for three of those years, there was no increase in tax rates.

This was in striking contrast to the situation in the last three preceding periods of military conflict. When the United States entered World War I, income taxes were increased sharply in 1917. Tax rates were also raised promptly in 1941 and 1942 in connection with World War II. At an early stage of the Korean conflict, tax rates were increased in 1950 and 1951. Again, however, in the case of the Vietnam War, it took a period of three years -- from mid-1965 to mid-1968 -- to increase tax rates.^{1/} During this period of inaction, the Federal budget deficit grew from \$1.6 billion to \$25.2 billion.

Compared with the increase in war-related Federal outlays, the deficit in the three years ending last June was close to the proportions registered during the two world wars -- and in dramatic contrast to the surplus achieved during the Korean episode. For instance, in the three fiscal years 1917-19, major national security outlays (including non-military but war-related international expenditures) increased by \$29.5 billion above the pre-war spending level of \$300 million per year. In the same period, the Federal budget deficit totaled \$23.3 billion -- or 79 per cent of the rise in war-related expenditures. In the five fiscal years 1941-45, military spending and related international outlays rose by

^{1/} Except for increases in Social Security tax rates which mainly served to finance increased benefits.

\$255.6 billion over the pre-war annual rate of \$1.5 billion. During the same years, the accumulated budget deficit amounted to \$190.2 billion -- a ratio of 74 per cent. But during the Korean War (spanning the three fiscal years 1951-53), a budget surplus of \$2.3 billion was achieved, while military outlays rose by a total of \$77.8 billion above the pre-war annual rate of \$13 billion. In the case of the Vietnam War, however, the situation has been radically different. Before the quickening of military activity, defense spending was at an annual rate of \$49.6 billion. In the three fiscal years 1966-68, war-related expenditures rose by a total of \$58.6 billion above the previous level. During the same three years ending last June, the Federal budget deficit totaled \$37.8 billion, or 64.5 per cent of the climb in war-related expenditures.

With the passage of the 10 per cent surtax in mid-1968, a sharp improvement was set in train. Reflecting this, for the fiscal year ending next June, a surplus of \$2.4 billion was expected (although the evolving evidence suggests that the full amount may not materialize). In the meantime, however, the earlier failure to cope adequately with the task of war financing produced the adverse effects many observers had foreseen.

Most economists would agree that during a war, the first step of Government financial policy should be an increase in income tax rates. The prime aim is not simply to raise revenue to finance the war. Rather it is to reduce purchasing power in the hands of the private sector -- which in turn lessens the latter's claims on real resources needed for the war effort. The failure to raise income tax rates in a timely fashion

after the quickening of the Vietnam War left the business and household sectors in a position to bid strongly for goods and services at a time when the Federal Government was also trying to increase its share. Moreover, because deficit financing expanded the purchasing power of businesses and consumers, they were able to bid even more aggressively for goods and services.

Thus, in the second quarter of 1965, the private sector accounted for 81.5 per cent of real gross national product (GNP, measured in 1958 dollars), and the Federal Government accounted for 9.4 per cent. In the fourth quarter of 1968, the private sector's share had declined slightly to 79 per cent, and the Federal Government's share had risen to 11 per cent. During the same period, real GNP rose by 18 per cent, but the amount of output absorbed by the private sector increased by 14 per cent. So, after more than three years of an expanding war, the private sector was still claiming almost as large a proportion of real output as at the time the military effort was accelerated. On the other hand, the Federal Government did succeed in expanding its share of real output. It absorbed about 20 per cent of the growth in real GNP during these 3-1/2 years, or over twice its share at the beginning of the period under review. A small part of the Federal Government's enlarged share of real output was provided by a modest shaving of private sector claims, and the rest was provided by a decline in the share going to State and local governments.

In terms of current prices, GNP rose by 31 per cent during the 3-1/2 years ending in December, 1968. However, since real output rose by

only 18 per cent, over two-fifths of the rise in money GNP represented higher prices. Taking the period as a whole, between mid-1965 and the end of 1968, the GNP implicit price deflator (the most broadly based of the price indexes) advanced at an annual rate of 3-1/2 per cent; in the previous 3-1/2 years the annual rate of increase was less than 2 per cent. In the case of consumer prices, the increase from mid-1965 to the end of 1968 was also at an annual rate of 3-1/2 per cent, against only 1-1/2 per cent at an annual rate in the preceding 3-1/2 years. Moreover, price advances were accelerating throughout the period, and the increases became more broadly based. These trends, in turn, generated growing expectations of still further inflation.

Against this evidence of rising inflationary pressures, the record of stabilization policies has not been very good. Beginning with the summer of 1965, the need for a less expansive fiscal policy became increasingly evident; and by early 1966 the need for a fiscal policy of considerable restraint was obvious to most observers. Although steps were taken to accelerate income tax collections and a few excise taxes (which were scheduled to expire) were kept on the books, higher income tax rates were not adopted until the summer of 1968.^{1/} In the absence of appropriate fiscal restraint, monetary policy was left to carry the main burden of countering inflation. This was especially true during the second half of 1966 and the first half of 1968. The lessons of that experience (particularly the 1966 episode) are by no means comforting. Mainly because of the rigidities surrounding home financing institutions,

^{1/} Social Security payroll taxes were increased to offset enlarged benefits.

the latter were able to compete for funds in only a limited way against the expansion in sales of market securities -- including a sizable rise in Government issues. Consequently, the housing sector, which depends heavily on the availability of funds at savings institutions, bore much of the impact of the reduced availability of credit in 1966.

Unfortunately, although the adoption of the surtax last June (and its probable continuation for at least another year) greatly improved the Government's fiscal situation, the outlook for the private economy suggests uncomfortable parallels with developments during 1966. Again, the disturbing element is a prospective boom in plant and equipment expenditures coming at a time of essentially full employment.

Moderating the Investment Boom

In my opinion, the projected rise in business fixed investment during the current year is in basic conflict with the priority assigned to achieving an early end to inflation. Thus, it poses a serious challenge to national stabilization policies.

The latest survey of anticipated business capital spending (conducted periodically by the Commerce Department's Office of Business Economics and the Securities and Exchange Commission) suggests a rise of 14 per cent in plant and equipment outlays in 1969. The survey was conducted in late January and early February and announced in the middle of this month. If these plans were fulfilled, business spending for new facilities would rise this year by \$9 billion to a total of \$73 billion. An increase of 14 per cent in the current year would be in sharp contrast

to the 4 per cent advance recorded in 1968 and the rise of 2 per cent in 1967. Apparently, the projected increase rests on a number of motivations -- including an expectation of large sales gains in 1969, the improved earnings position in 1968, efforts to expand capacity to meet long-run demand, and the desire to substitute capital for labor wherever possible.

The OBE-SEC survey indicates that the projected rise in capital outlays is broadly based, with manufacturing industries expecting a gain of 16 per cent, and the nonmanufacturing sector expecting an increase of 12 per cent. Although some of the anticipated advance in plant and equipment outlays may not be realized (and some of the projected increase reflects higher prices rather than real investment), the planned increase still represents a substantial rise in private claims on resources at a time of serious inflation. Furthermore, the sizable expansion is projected despite the fact that the capacity utilization rate in manufacturing averaged 84 per cent during the second half of 1968 -- well below the preferred rate of 90-92 per cent.

While one might expect some short-fall between projected and actual outlays on fixed equipment, there is also a good chance that plans may be realized substantially -- unless public policy is brought to bear. This was certainly the case during the 1966 fixed investment boom. In November, 1965, the OBE-SEC survey indicated that plant and equipment outlays during the second quarter of the following year were projected to show an increase of 14 per cent over the annual average for 1965. By the time of the March, 1966, survey, such outlays were projected to show an increase of 16 per cent during the full year over the 1965 level. The

actual increase in 1966 was 16.7 per cent. Thus, during a period of strong business anticipations, the projected increases in plant and equipment expenditures indicated in the OBE-SEC survey may understate actual outlays.

On the other hand, the latest plans apparently were made before monetary policy became as restrictive as it is currently. Thus, actual spending should run lower -- and as corporations conclude that the monetary and fiscal authorities are fully committed to fighting inflation -- and in fact are making substantial progress -- business investment outlays undoubtedly will be reduced considerably.

Consequently, in my personal opinion, we ought not to hasten to conclude that the 7 per cent investment tax credit should be suspended as a move to dampen business capital outlays -- as some observers are suggesting. Certainly the off-on experience along this line in 1966-1967 provides little to encourage one to be hopeful about the beneficial results of such a move. Rather, it seems preferable to rely on the steady and vigorous application of the general instruments of monetary and fiscal policy.

In making this observation, let me say that I realize that some of the projected increases in plant and equipment are based on long-run considerations, and many projects will not be ready to produce until 1970 and 1971. Nevertheless, I think the impact of fiscal and monetary restraint -- if pursued long enough -- will have a dampening effect on this part of the spending stream.

The Role of Monetary Policy

Despite the possible delays in the impact of monetary policy in moderating plant and equipment expenditures, I must emphasize that we have already achieved a substantial degree of monetary restraint since the end of 1968.

For example, during the first three months of this year, total bank credit (as measured by the credit proxy) may decline by almost 5 per cent at an annual rate: during the last quarter of 1968, such credit expanded at a 12 per cent annual rate. Even after adjusting for increased Euro-dollar borrowings abroad by head offices of U. S. banks, the decline in bank credit during the first quarter may be close to 2 per cent at an annual rate. In the first three months of this year, the annual growth rate of the money stock may be reduced to 2 per cent compared with 7-1/2 per cent in the fourth quarter of last year. Time and savings deposits at commercial banks are projected to decline at an annual rate close to 7 per cent during the January-March months, in contrast to an annual rate of expansion of 16 per cent in the final three months of 1968. The principal explanation of this sharp turnaround is the substantial attrition in CD's at large banks -- which have shrunk by \$3-1/2 to \$4 billion since the beginning of the year.

Under these pressures, banks are finding it increasingly necessary to tighten lending terms. The banks' prime lending interest rate has been raised from 6-1/4 to 7-1/2 per cent since early December; and counting the effects of compensating balances, the minimum cost of borrowing even for the best customers now exceeds 9 per cent. More and more banks are turning down new loan requests, and demands which ordinarily would have been met at the large money market banks are being shifted increasingly to smaller regional institutions. Loan deposit ratios in many instances are as high as they were during the period of severest

credit restraint in 1966. Other measures of bank liquidity tell the same story. With the passage of each week, banks are increasingly reducing their participation in the market for State and local government securities, and net sales of Federal Government issues remain large. Borrowing from Federal Reserve Banks has risen sharply, and the liabilities of head offices of U. S. banks to their foreign branches have climbed to over \$9.8 billion, compared with an average of \$7 billion last December. Again, these indicators suggest that a substantial degree of monetary restraint has been accomplished.

On the other hand, we must accept the fact that the effects of monetary policy on spending for goods and services and on prices are registered after a significant time lag. This is partly because strategically placed sectors may have built up a liquidity cushion that must be worked off -- while others may occupy favored positions with lenders. This is especially true of the relationship between many corporations and commercial banks. To a considerable extent, this accounts for the fact that business loans in January and February this year rose at an annual rate of 19 per cent, compared with 13 per cent during last November and December and with 11 per cent in the second half of 1968. While the rate of growth eased somewhat in the month of February (data for March are still fragmentary), the pace of expansion continues to be much greater than is compatible with the effort to check inflation. Thus, the proper stance for monetary policy is clear: restraint must be maintained in sufficient degree to induce banks to decrease even further the pace at which they are taking on new commitments and the rate at which they are

expanding loans and investments. This posture of restraint should be held for a long enough period of time to convince everyone that borrowing and spending decisions must be revised downward to levels consistent with the maintenance of noninflationary growth in the long-run.

Unpromising Alternatives

As I mentioned above, several different courses are being urged (some openly, others quietly) as alternatives to a policy of monetary and fiscal restraint as a means of coping with inflation. These include suggestions that the Federal Reserve sponsor a scheme of voluntary credit allocation to domestic borrowers and that Congress adopt direct controls over wages and prices. Still another suggestion is that no serious effort be made to check inflation because such an attempt may result in higher unemployment and increased tensions in urban areas. In my opinion, these are not meaningful alternatives.

I can appreciate the reluctance of banks to say "no" to customers with whom they have had a long-standing relationship. I can also understand their fear that if they turn down a customer he may easily be accommodated by a competitor -- who may also get the balances previously held with the first bank. It is these kinds of concerns which have led some bankers to suggest that it might be a good idea for the Federal Reserve System to encourage the adoption of a voluntary control program under which banks and other lenders can agree on credit rationing among different types of borrowers.

Of course, I cannot speak for others in the Federal Reserve System, but I would find it difficult to support such a proposal. On the basis of my own experience with another voluntary credit restraint program (to limit foreign lending by American banks and nonbank financial institutions), I am convinced that the inequities which such a scheme must necessarily involve would be extremely serious. Lenders and borrowers with favored positions at the beginning of the program would be able to exploit their advantage and strengthen their own competitive positions. Those not so favored would have their positions worsened. Moreover, lenders who had to make unpopular turndowns of loan requests naturally would find the program a convenient crutch. Since such a scheme would probably have to include some means of getting "exceptions," the administrative burden (which necessarily would be considerable) would become even greater. Thus, the launching of a voluntary program for the allocation of credit to domestic borrowers would pose a serious interference with the conduct of monetary policy, and it would probably do little to reach the basic source of the inflationary pressures.

This is even more true of mandatory controls over wages and prices. Such controls in this country have been associated with an all-out war effort, and they have been accompanied by other measures (such as higher taxes and materials allocation) which re-inforced them. Even so, the extent of their success is not at all clear. In World Wars I and II, the main effect of the controls seems to have been to suppress

excess demand during the war years -- which was subsequently registered in substantial post-war inflations. During the Korean War, the imposition of direct controls along with higher taxes seems to have eased expectations of further inflation; so after the first year of the war effort, price increases were relatively moderate.

However, in my judgment, the key point about such controls is that they cannot be expected to work except as part of a comprehensive system of war-time regulations. Since such a system does not appear to be called for, I think it best that no serious effort be made to impose wage and price controls. Instead, a vigorous policy of monetary and fiscal restraint seems sufficient to cope with the current inflation.

Finally, as I have stressed throughout these remarks, I think the task to checking inflation is urgent. Therefore, I cannot share the view which holds that such an effort is too costly when measured in terms of its impact on unemployment and the need to improve the conditions of life in urban areas.

I am fully aware of the fact that the rapid expansion of the economy in recent years has been especially helpful to marginal groups in the labor force. For example, the unemployment rate for nonwhites averaged 8.1 per cent in 1965, compared with 4.5 per cent for all civilian workers. By 1968, the nonwhite rate had declined to an average of 6.7 per cent, against 3.6 per cent for the total civilian labor force. In the last year, the improvement in the employment situation has been particularly striking for those living in urban poverty areas. Between the fourth

quarters of 1967 and 1968, the unemployment rates in poverty neighborhoods of the nation's 100 largest metropolitan areas declined from 6.9 per cent to 5.2 per cent. This rate of improvement was faster than that in other neighborhoods of the 100 areas -- or in the nation as a whole.

Thus, I am obviously reluctant to see circumstances develop which would limit or erase this progress. Nevertheless, I do not agree that such reluctance should lead to a slowdown in the campaign against inflation. After all, whatever improvement in employment and income the poor and disadvantaged can achieve will be of even greater benefit if it is not eroded by rising prices.

Instead, as I stressed above, I think one must look to the further expansion of training, health, housing and other public programs as means of ensuring that the poor and disadvantaged do not carry the main burden of checking inflation. In the meantime, the task for national stabilization policies is clear: it is to push the fight against inflation. As one who shares in the development and execution of these policies, I have no doubts about my own responsibilities.