FOR RELEASE ON DELIVERY
MONDAY, DECEMBER 3, 1979
2:30 P.M. E.S.T.

ENERGY, GOVERNMENT AND MONETARY POLICY

Remarks of

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before the

American Gas Association Annual Gas Industry Bankers Conference

Washington, D. C.
December 3, 1979

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It is probably an overstatement to say that energy is the sole and all-consuming economic and financial problem of the United States, but it is not an overstatement to say that energy is a major and important problem for this nation, and indeed for the world as a whole. For the United States, direct energy costs are nearly 6 percent of the gross national product, but with an additional indirect impact for most of the goods and services produced in the nation. Price changes for energy over the past few years have been at rates far in excess of any other principal commodity and just since the first of 1979, have risen at an annual rate of 43 percent. Imported energy, principally oil and natural gas, now account for 30 percent of the U.S. imports on a value basis and at an estimated 66-1/2 billions of dollars, such imports offset more than one-third of total export earnings of the United States.

But these cold statistics probably do not convey the flavor of the important impact of energy availability or energy costs. Many problems have been isolated over the past few years with regard to energy including some of the most important issues facing the free world today.

- Just on the domestic side, the sharp increases in the prices of oil and gasoline have diverted sizable shares of consumer disposable income from purchase of other goods and services. The diversion of consumer disposable income is likely to be even greater as the higher oil prices are reflected in heating oil purchases over the coming winter season.

- This diversion of consumer disposable income has reduced the savings potential of our people and has cut the availability of long-term savings for use in capital spending.

- The diversion of income has been particularly heavy upon the low-income groups and has fostered government subsidies to reduce the impact upon such groups.

- As a prime source of inflationary pressure in the United States, energy costs have been a major reason for the upward pressure on prices throughout the goods and services produced in this country, as well as those imported from abroad.

Energy costs and availability have been important factors in determining government policies, including the uneconomic and seemingly random shifts of energy reliance between oil and other sources of power. It has brought the United States to a position of resisting price change internally, both with subsidies and price controls, and has created the potential for a further erosion of the free enterprise, capitalistic system that we have followed for so many years.

The whole energy problem has been a source of significant monetary unrest with the gauge of a country's wealth and power seemingly measured by world traders on the strength and availability of energy sources rather than the broad and general strength of total wealth, capital outlays, export potential, and standards of living of people in a particular nation.

Internationally, the energy problem has created significant loss of independence in world power politics and, with overdependence upon foreign sources of energy, we have become less capable of determining our own future and less able to adopt policies which we believe to be desirable, for fear of antagonizing the sources of this particular commodity.

It is clear that the major oil imports into this country have created a potential for a major transfer of wealth with dollar payments abroad, providing the funds for investment and ownership of companies, banks, land, and other resources in the United States. In the financial area the energy problem and resultant payments have occasioned a sizable recycling difficulty, moving the very large payments from the oil-producing countries back through the banking system into loans to the nonoil-producing, less-developed countries to aid in their battle against inflation and continued development. From 1973 through 1978 the recycling job has been accomplished largely through the banking system with increases in international lending to nonoil LDCs amounting to nearly $100 billion, while the oil-producing countries have found the means of utilizing a share of their new-found wealth in the development of their own countries. In a few cases such producers so rapidly developed new projects that oil production has become a necessity to make payment on the loans to finance them. The new-found wealth of the oil-producing countries is not an unmixed blessing, however, since the revenues paid to these countries for their oil exports has so enlarged their money supplies as to create a substantial increase in inflationary potentials. Prices of imported goods adjusting to the higher oil price structure as well as domestic prices reflecting expectations and actual demand of the people, have risen sharply in almost every country.

Government policy throughout the world has reacted to this new strain on the economic and financial posture of each nation in varying ways, but a common thread has been one of resisting, to the extent possible, the impact of energy costs from disrupting national life both in the sense of reducing the cost of such imports or reducing the inflationary impact upon the price levels of the particular country.

Throughout the period the shift in exchange rates has accomplished some of this adjustment procedure, but the principal adjustments have taken place in import and export prices and in the interrelationship of these prices both at home and abroad.

Of prime importance to government policy has been the protection of the disadvantaged but even here it has not been possible for governments to completely shield their populations from the impact of energy problems. Government policy questions which have been faced and to a large extent compromised have been the questions of free market price and production versus controlled prices and subsidies; economic stabilization, whether reducing activities in other areas will offset the price and output impacts of a less freely available energy source; and finally the questions of self-protection through an energy independence policy by subsidizing new sources of energy compared with a private funding through price increases. On the international side, central bank intervention or policy shifts to protect exchange values have also been important.

Nevertheless, one must keep in perspective the degree of shift relative to the sources and requirements of the U.S. or any other country's problems in attempting to manage these difficulties because there are other major changes underway in both geopolitical and politico-economic movements which have impacted upon the well-being of individual nations. Relative policies of containment in the financial and fiscal area, as well as policies of protectionism versus free trade have had similarly important impacts upon the position of particular nations.

The choice of the individual countries as to their desirability to move from one policy to another or to emphasize one part of a policy versus another, is and has been an important ingredient in the entire array of political and economic power throughout the world. It is part of this policy to which I wish to address the remainder of my remarks this morning.

It has become increasingly popular throughout the world to address a nation's monetary policies toward what has been known and is becoming familiar to most Americans as the monetarist school. Such policies concentrate their attention upon the supply of money and credit available to a nation and in effect demand that such supply be kept at a relatively slow and non-inflationary growth path as a means of restraining price increases throughout a country. Such a mechanistic approach to monetary policy has obvious problems when faced with a significant external shock of a large oil price increase or other import price advances, and leaves less than full flexibility for government policy in this area.

But the fundamental problem facing the monetary authorities of the world is the choice of funding the price increases, whether domestic or external, and the resultant advances in nominal gross national product, or curtailing such increases by less than full funding to resist price inflation.

The creation of money supply to offset the tax effect of energy price increases is a route to significant inflationary pressures and aids and abets the continued advances of such prices and the spread of the price impact throughout a nation's economy. As evident in periods of rapid inflation, monetary authorities are faced with balancing the risk of recession and higher unemployment compared to a continued funding of high, if not rising, inflation. It is obviously a difficult decision for government to restrict economic growth and improved standards of living, or risk a greater shock to current rates of expansion by higher inflation.

The balance of domestic risk of slow growth, or even stagnation, against continued inflationary funding is a significant and indeed heart-rending decision. However, it is one which government must make and one over which the individuals in a free enterprise society have relatively little control. In the United States this decision has been one which has varied from a compromise of gradualism to a more positive policy of containment which would reduce the availability of credit throughout the nation but at a pace which would hopefully reduce the risks of a deep recession. If indeed monetary policy were a science which could be handled by sheer mathematics and a plug compatible point of rate of growth, the policy could be set without reference to the other internal changes of the United States and we could set this rate of growth in such a way as to be precise in limiting price increases in this country. But this would expose us to a considerable period of the stagflation potentials so visible on the horizon.

The determination of monetary policy is still an art rather than a science and the balance of forces in a shifting and changing economic world makes the policy decisions even more difficult and more uncertain in their ultimate resolution. The impact of the recent moves of the Federal Reserve toward containing the rate of growth of the money supply in the United States, given the very sharp increases in bank credit evident thus far in 1979, launches the United States again on a policy of moderating economic growth to contain inflationary pressures at home and abroad. It is an important policy shift because the emphasis on interest rates by themselves was clearly not sufficient to overcome the inflationary expectations of businessmen and consumers who were willing to pay steadily rising prices for credit in the form of higher interest rates as long as they could envision a rate of return which would be even higher. In other words, the Federal Reserve has now gone back to a containment of the basic source of credit creation, the high-powered central bank reserves, with the objective of limiting such reserves to an economy which in the recent past was becoming accustomed to almost freely available funds at a rising interest cost.

While we expect this policy to bear significant fruits in reducing inflationary pressures from internally generated sources, it is not likely that this policy will be able to meet the challenge of a sharply rising energy cost from external sources. A major increase in OPEC prices during December would obviously compromise the results of this policy and once again provide a cost impetus not likely to be contained by sheer monetary restraint without bringing the country to a point of almost standstill or at least significantly lower rates of growth in the coming years. On the assumption that price increases from OPEC will not dramatically exceed over-all inflation rates, one could envision the economic stabilization policies of government as leading to much lower rates of inflation than evident in 1979.

One must be careful, however, to point out that the job of economic stabilization cannot be done by monetary policy alone. The impact of the current degree of restraint in monetary policy would be intolerable as a long-run position. If we were to restrain the economy with greater severity as to provide no advances in real gross national product, or little expansive capability in capital spending, the economy would regress and unemployment would move on an upward trend.

Oil prices, therefore, are a significant factor in most of our considerations of the future of the U.S. economy, but they are still only one part of that over-all complex. Another important feature relates to the willingness of our people to save and the willingness of our businessmen to invest in capital spending programs to provide new job opportunities and improve the productivity in our nation's labor force. Without improved capital spending programs and without the job opportunities evident from them, our nation may be condemned to being a consuming rather than a producing and consuming nation. This basic consumption outlook is hardly one which could give comfort to those looking forward to a long-run posture of world power and economic progress. A sizable share of the responsibility of meeting this latter challenge lies in fiscal policy of government to support the policies of self-sufficiency and free enterprise and a tax policy of encouragement to capital investment. The latter is particularly important in the area of depreciation write-off times. Fiscal policy is also important in containing other government spending programs which have sapped the strength of our free enterprise system for so many years. But we as individuals and members of the business establishment have a clear responsibility to send signals of self-reliance and individual resolution of problems at the local level and to demonstrate our willingness to seek governmental solutions of broad applicability rather than those of limited self-interest.

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