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Remarks by

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

to the

Swiss-American Society Basel

Basel, Switzerland

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The U.S. economy has moved into recession after reaching what were probably the highest levels of both inflation and of interest rates in the history of the Federal Reserve. Throughout most of the past 18 months, a recession was being predicted without materializing. Instead, the United States experienced an unexpected and unpredicted acceleration of inflation. These events suggest that the threat of inflation was underestimated and the measures initially taken inadequate, even though the control of inflation had been singled out as the nation's number one economic objective.

The escalation of the consumer price index during the first quarter of 1980 to 18 percent was not entirely a failure of policy. The rise in OPEC oil prices contributed substantially, and so did the domestic deregulation of oil prices which was an essential component of realistic energy policy. During much of 1979, however, there prevailed also a condition of excess demand that was not adequately recognized. Because unemployment at about 6 percent was high by historical standards and capacity utilization in manufacturing at 85 percent was somewhat low by

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historical standards, it had not been fully realized that pressure on capacity was nevertheless driving up prices. Evidently there have been changes in the American economy, including the demographic structure of the labor force, improved unemployment compensation, reduced profitability due to higher energy prices, and obsolescence due to inadequate investment, that have lowered the threshold, both in terms of unemployment and industrial capacity, at which wage and price pressures begin.

A favorable factor was the relative moderation in wage increases. Real wages of the American worker fell by 4 percent during 1979 as in the face of a 13 percent rise in the consumer price index, compensation per hour rose by only 9 percent. American workers accepted a significant reduction in their standard of living. But productivity performance also was extremely poor, with productivity in the private sector falling by 1 percent during 1979, partly in consequence of government regulations and other actions that increased costs. Unit labor costs, therefore, rose by 10 percent in 1979, a rate that must be regarded as reflecting the so-called underlying rate of inflation.

To round out the picture of the recent American inflation, it needs to be noted that the consumer price index has tended to overstate the price increase relevant for the great majority of the population because of the heavy weight that it gives to the price of homes and to mortgage interest rates. When mortgage rates come down, as they already have begun to do, the index will, with a lag, begin to understate the inflation. We should not be deceived by an improvement due to this source, just as we are entitled to make some allowance for the recent upward exaggeration of the index. A more meaningful index of the rise

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in living costs for the entire population is the personal consumption expenditures deflator, derived in our national income accounts, which during 1979 was advancing at 9 percent.

It is worth noting that, during the period of accelerating inflation, interest rates more or less kept pace with the rise in prices, although much of the time lagging somewhat behind. During the early part of 1979, real interest rates -- nominal rates minus inflation -- probably were somewhat on the negative side. In 1980 they became somewhat positive, bearing in mind that all statements about real interest rates are subject to a margin of uncertainty. A similar phenomenon can be observed in most countries that experienced an acceleration both of inflation and of interest rates during 1979, although the degree to which real rates were positive varies considerably among countries. To some extent this parallelism may be attributable to tighter monetary policy aiming to restrain inflation. In some measure, however, there may be a more automatic mechanism at work reflecting possibly the greater awareness of inflation among borrowers and lenders and the more rapid upward adjustment of inflationary expectations. The importance of real interest rates after tax, however, varies among countries and is probably greatest for the United States, where interest payments are tax deductible not only for businesses, but also for home owners and other consumers. The subsidization of borrowing through this device probably has contributed to the severe decline in the savings rate that has taken place in the United States.

By the same token, it appears that the United States economy is more vulnerable, in many respects, to the damage wrought by inflation than are other economies. The tax system has not been adapted to inflation,

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except in the main for periodic personal tax cuts that have helped to offset the drift of taxpayers into higher brackets. Savings institutions have found it very difficult to cope with inflation, which has led to severe damage to the housing industry. Usury ceilings, only in part recently overruled by the Congress, have interfered with the flow of credit at high interest rates. Business profits are grossly overstated by an accounting system that ignores inflation. The development of an underground economy, which has helped some economies defend themselves against inflation in some degree, has been largely forestalled in the United States by the effective administration of a tax and legal system that, all pressures not withstanding, continues to perform effectively. It is not surprising, therefore, that among countries with high rates of inflation the United States probably has had the worst productivity experience.

Three Rounds of Monetary Action

Three rounds of monetary action mark the course of monetary policy over the last year and a half. The measures of November 1, 1978, represent the first round.

November 1, 1978. The immediate objective of the steps taken on that date was the strengthening of the dollar, which over the previous five months had declined from 96 to 89 on its trade-weighted rate against the currencies of the G-10 countries and Switzerland. An important part of the action was executed by the Treasury, which undertook to borrow in foreign currencies, to use its SDR holdings, and to draw on the International Monetary Fund. Together with the swap lines available to the Federal Reserve and the Treasury, an intervention package of $30 billion was readied and a

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more forceful approach to intervention was announced in support of the dollar which was regarded as having declined to unjustifiable levels. The Federal Reserve raised the discount rate by a full percentage point from 8-1/2 to 9-1/2, an increase matched only once in recent history.

During the period from October 1978 through March 1979, the monetary aggregates advanced very sluggishly. The dollar improved but fell back again after May 1979. The sluggishness of the aggregates conveyed an impression of monetary restraint which, coupled with the widespread expectation of a recession, created unduly optimistic expectations concerning future inflation. Meanwhile, the moderate increase in interest rates failed to have its usual pronounced impact on the housing industry, because the institutions financing the industry had been permitted to issue market-oriented debt instruments that protected them against the outflow of low interest deposits that normally would have occurred at high market rates of interest. Thus, a level of interest rates that under other conditions might have been sufficient to slow the economy did not achieve this result. Shielding one sector of the economy against the impact of high rates evidently had as its consequence the need for still higher rates to do the same job.

October 6, 1979. In the spring of 1979 the monetary aggregates, until then dormant, began to accelerate once more. Their rapid growth during the summer made clear that further vigorous monetary action was needed in the face of rising inflation. After the dollar began to decline sharply and commodity prices began to climb rapidly in September 1979, the Federal Reserve on October 6 took a set of measures that constituted in effect the second round of monetary tightening. A new and more rigorous

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technique of controlling the money supply was instituted, based primarily on the use of bank reserves instead of the federal funds rate. Reserve requirements were imposed on increases in managed liabilities above a base date. The discount rate was raised from 11 to 12.

These actions brought an immediate change in the bank credit picture. Bank credit had been easy at high rates. It now became less readily available. Interest rates rose dramatically. The monetary aggregates came under good control.

Meanwhile, however, the high nominal interest rates to which the economy was moving, while barely positive in real terms and apparently still insufficient to curb adequately the aggregate volume of credit, began to create problems for particular lines of business and some financial institutions. Home builders, farmers, small businessmen and automobile dealers found the high nominal cost of credit and, in some cases its nonavailability to particular borrowers, extremely burdensome. Savings institutions and many small banks found themselves squeezed between the risk of losing their deposits to higher paying investment media, especially money market mutual funds, and, on the other side, the danger of attrition of their earnings, as the cost of the money they were able to retain began to exceed the income from their portfolio of fixed interest rate loans and mortgages.

This dilemma was the consequence, in good part, of an earlier effort to shield these lending institutions against "disintermediation" by allowing them to issue money market certificates and other obligations at market-oriented interest rates, well in excess of the deposit rate ceilings imposed by Regulation Q. Their earlier liquidity problem resulting from withdrawal of deposits now became converted into an earnings problem due to the increasing interest cost of these new obligations.

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In addition to these differential impacts of high nominal interest rates on different types of lenders and borrowers, the impact of real after-tax interest rates on different borrowers became increasingly apparent. High-bracket taxpayers, including large corporations, were shielded by the tax deductibility of high nominal interest rates which for them signified mainly a cash flow stringency. Low-bracket taxpayers, and firms without positive earnings, felt the full brunt of high nominal rates both in terms of cash flow and cost. Thus, it became apparent that a tight monetary policy may find itself limited by the side effects it produces before rates have become high enough, especially in real terms and after taxes, to curb inflation.

Moreover, it became apparent also that the availability constraints which the second round of measures, of October 6, 1979, had initially brought about had begun to wear off. Credit once more became freely available at least to large borrowers at very high rates. Bank credit expansion continued strong in January and February 1980. The monetary aggregates, which had been under good control following the October 6 measures, broke out on the upside in February.

March 14, 1980. These were the conditions that led to the third round of credit tightening. The principal part of the new measures took the form of direct credit controls authorized by the President under the Credit Control Act of 1969. A "voluntary" limit of six to nine percent, intended to be firmly administered, was placed on the expansion of domestic bank loans to domestic customers. Consumer credit was restrained by imposition of the equivalent of a reserve requirement on credit card and other retail lenders. Nonmember banks were subjected to the equivalent of a reserve requirement, as were money market mutual funds. The marginal reserve requirements

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established in the second round of measures were tightened. A penalty discount rate was established for large banks frequently using the discount window. The cooperation of foreign banks in not undermining the 6-9 percent loan expansion limit was sought through their respective central banks.

It is too early to assess fully the specific effect of the imposition of credit controls. In particular it is difficult to distinguish their effect from the cumulative impact of earlier monetary actions and from the impact also of developments outside the monetary sphere. Interest rates rose further following the March 14 controls but quickly peaked and thereafter dropped dramatically. The monetary aggregates, which had been expected to expand further, declined in March and showed an unprecedented drop in April. Bank credit slowed sharply.

The sudden contraction of the monetary aggregates confronted the Federal Reserve with a dilemma. To meet its short-run money supply targets, the Federal Reserve would have had to supply reserves to the banks through open market operations on a much enlarged scale, since with falling money market rates it was to be expected that the banks would, as indeed they did, sharply reduce the volume of reserves they previously had obtained through the discount window. Excess reserves would have resulted at least temporarily. Sizable excess reserves would have caused money market rates as well as others to drop even more sharply, posing a threat to the dollar. Failure to force reserves upon the banks in order to avoid an extreme drop in interest rates, on the other hand, would cause the Federal Reserve to fall short, at least temporarily, of its money supply target.

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In setting its short-run money supply targets, at monthly FOMC meetings, the Federal Reserve had established upper and lower limits for the federal funds rate (interbank rate). These limits started out at 11-1/2 - 15-1/2 percent in October 1979 and had moved to 13-19 percent by April 1980. The lower limit was subsequently reduced to 10-1/2 percent by a telephone conference of the Federal Open Market Committee on May 6, 1980, but it did serve to limit the precipitous drop in interest rates in some measure.

Meanwhile, the decline in interest rates has also brought alignments that are indicative of the market's expectations. The drop in 90-day rates amounted to approximately three times the drop in long-term rates. At present, the normal upward sloping yield curve has been reestablished, with the highest rates at the long end and a spread, as of June 3, 1980, of about 2-3/4 percentage points between 90-day and 30-year governments, and 1-1/2 percent between commercial paper and long-term bond rates, high in historical terms. This configuration is indicative of market expectations that rates are more likely to go up than down. That message is underscored by the prices quoted for Treasury bill futures, which show a mildly rising trend in the 90-day Treasury bill rate beginning in mid-1980.

Problems of Direct Credit Controls

The change in the economic climate following the introduction of quantitative credit controls, whether initiated or merely accelerated by these controls, very quickly has posed the question of their dismantling. This "Encadrement de Credit," as it is known in France, or "Window Guidance" as it is called in Japan, is not suitable as a permanent instrument of monetary policy in the United States, even though in some other countries

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such techniques constitute a permanent part of the monetary policy toolchest. The brief experience of the Federal Reserve with the administration of these devices bears this out. They involve credit allocation to competing groups of borrowers. This is a political decision that should not be required to be made by the central bank. But when made by the political process, credit is likely to be allocated not where it produces the most goods and services, but where it produces the most votes. Any rationing of credit other than through the price, i.e., the interest rate, is bound to be arbitrary and probably in many instances unfair. Unrealistic decisions have to be made as to what types of loans are "productive" and "unproductive." The productivity performance of the American economy, already very inferior, would become further depressed.

The market, moreover, can be relied upon to learn to circumvent whatever controls are imposed. If the banks are controlled, credit will move out of the banking system, perhaps permanently reducing the banks' role and their capability to serve the economy. If other domestic sources of credit are also controlled, the business will be driven abroad. Credit controls are like wage and price controls. They may provide short-term relief, but in the long run they are not only ineffectual but damaging. They present a temptation to politicians, because they seem to offer a means of fighting inflation without high interest rates. If that temptation is not resisted, the consequences will have to be added to the already long roster of damages caused by inflation. The Federal Reserve moved in the direction of dismantling the controls by enacting measures on May 22, 1980, which reduced a significant portion of them without, however, materially altering the 6-9 percent bank loan limit.

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Implications for Monetary Policy

Recent U.S. experience with a rigorously pursued money supply target highlights some of the salient characteristics of this form of monetary policy. In general, it is true, of course, that in a period of high inflation a money supply target is preferable to an interest rate target. Inflation plays havoc with the meaning of interest rates, since nominal, real and real after tax rates all have different impacts on different borrowers and lenders. It is then good policy to follow a money supply target that can be counted on to bring down inflation in the long run. It will do so by inducing interest rates in the market that will impose a restraint on economic expansion adequate to the purpose. It would be difficult to define those interest rates *a priori*.

It remains true, however, that the economy is steered by interest rates, in their broadest sense, including rates of return on physical capital. Money does not exert some mysterious diverse effect in determining the demand for goods and services. Interest rates, therefore, continue to be important.

When the Federal Reserve went on a rigorous money supply target in October 1979, it was aware that this might lead to greater volatility of interest rates and so informed the market. Interest rates would be more volatile under a rigorous money supply target even if the economy were moving along normally and only the demand for money fluctuated around its trend, as it usually does. Small differences between the amount of money supplied and the amount of money demanded will then be eliminated by interest rate movements. But when the demand for money changes drastically as a result of a major cyclical swing, interest rate movements can indeed become very wide. Such major swings occurred late in 1979 and early 1980. First, accelerating

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inflation, combined with rising economic activity, greatly increased the demand for money. A sharp rise in interest rates was the result. Then, during the second quarter of the year, a turn toward recession caused the demand for money to drop sharply. Interest rates, therefore, came down dramatically.

Both the earlier upswing and the subsequent decline in interest rates probably were larger than central banks normally would seek if they were pursuing an interest rate target. This makes clear the implicit purpose of a rigorous money supply target: to induce very wide swings in interest rates that can be expected to have strong anti-cyclical effects.

Short-term interest rates that within a few months can move from 10 to 20 percent and within a few weeks back to less than 10 are strong medicine. They certainly seem capable of stopping an expansion. How effective they can be in ending a contraction remains to be seen. But past history suggests that a decline in interest rates indeed can promote a shift from contraction to expansion once other necessary adjustments in the economy, such as the clearing out of excess inventories, the working off of unprofitable investments, and the restoration of better balance in business and household balance sheets has occurred. A rigorous money supply target, in other words, is anything but a neutral, do-nothing, or even benign neglect policy. It is a highly activist policy which is likely to affect a cyclical economy with much greater strength than the kind of interest rate oriented monetary policy historically conducted by central banks. This is particularly the case during high inflation.

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The acid test of the ability of a rigorous money supply policy in dealing with inflation is yet to come. It may well come soon after the American economy turns around and resumes its expansion. Unless the inflation by that time has been greatly reduced, there will be a strong demand for money fueled by both real growth and continuing inflation. Together these would add up to a rate of growth of nominal income probably well in excess of 10 percent. This will be a sizable amount of nominal growth to be financed with a money supply expanding at a rate of 3-1/2 - 6 percent, the present M-1A target range.

A large rise in velocity will be needed to make this possible. Historically, to be sure, velocity often has risen strongly during the first year of a cyclical recovery, probably because a certain amount of idle liquidity is accumulated during the recession. But over longer periods a rate of money growth substantially below the growth rate of GNP in nominal terms is likely to cause interest rates to rise. It is precisely such restraint that will be needed to keep the economy from going off into another wave of inflation. But this will require a willingness to move out of the recession slowly, and to accept some slack as growth is resumed until the inflation has been wrung out of the system. That must remain the principal objective. The acid test of whether it can be attained is likely to occur, not during the recession, but during the succeeding upswing.

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