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"THREE CURRENT FALLACIES CONCERNING MONETARY POLICY"

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In attempting to assess what we have accomplished in monetary policy in 1969 and the implications for the future, I plan to proceed by examining three fallacies concerning the current monetary policy which I find regularly appearing in the financial press. In so doing, I would like to emphasize the obvious - - that I am speaking only for myself and not for the Federal Reserve System.

The first of these erroneous ideas is the proposition that monetary policy is not working and that, if we are to control inflation, we will need to turn to wage and price controls.

The second erroneous notion is that monetary policy has not worked because the larger banks have been able to circumvent the impact of the tight money policy through the Euro-dollar market, repurchase agreements, the commercial paper market, and other devices.

A third fallacious idea is monetary policy cannot have any significant impact on the rate of increase in the price level unless it generates a full-blown recession.

In my judgment, not only are these three ideas fallacious, but they tend to accentuate the inflation psychology by generating a sense of despair that we will ever get on top of our inflation problem. Because I think these ideas are wrong, I believe that any businessman or investor who places his money on them is running the risk of making a serious mistake.

Let us look at the first idea. Is it reasonable to take the position that monetary policy has failed and that we ought to turn to wage and price controls? I think not, for two reasons: first, monetary policy, in my judgment, has not failed and, second, wage and price controls would certainly fail if we were foolish enough to resort to them.

Those who feel monetary policy has failed to work do not understand how it works - - in particular, they do not understand the time lags involved between a change in monetary policy and the resulting impact on the economy, especially in those situations, such as the present, where the economy had generated a full head of steam.

The problem of cooling off an overheated economy is analogous to the problem of cooling off an overheated house. Let us take the case of a man who returns home from vacation to find that the temperature in his house is 90 degrees. Being fortunate enough to have a house which is air conditioned, he immediately turns on the air conditioning system, confident in the knowledge that in time the temperature will be brought down to a comfortable 70 degrees. However, from experience he knows that the process is going to take some time to accomplish. No matter how effective the air conditioning equipment, it cannot immediately drop the temperature in the house to 70 degrees, and it will not speed up the process one bit to set the thermostat at 60 degrees instead of 70 degrees. Having taken the required action in turning on the air conditioning system, he can only be patient while the time-consuming process required to cool the overheating takes place.

To deal with the overheated economy of 1969, the Federal Reserve turned on the monetary air conditioning in December 1968. The results thus far have been severely disappointing to those who do not understand that monetary policy, like air conditioning, operates with a considerable and inevitable lag on a seriously overheated economy. I believe we now have some considerable evidence that the cooling process has started, and I believe that by Christmas there will be a much broader awareness that monetary policy is, in fact, working. In saying this, I am not suggesting that the temperature in the house will be down to 70 degrees by Christmas, but by that time we will be able to agree that the temperature is clearly going down.

The last time we had such a severely restrictive monetary policy was in 1966. I believe there is general agreement among economists that monetary policy worked in 1966 and that it was largely responsible for the pronounced slowing in economic activity during the first half of 1967 and the cooling of inflationary pressures which then occurred. It might be instructive to compare how we are doing thus far in 1969 with the record of the corresponding stage of 1966.

First, has monetary policy been as tight in 1969 as it was in 1966? I think the answer must be "yes" - - by some measures it has been tighter. To give you a few statistics, during the first ten months of 1966 the conventionally defined money supply was up at an annual rate of 2.5% compared to a 2.7% rate of gain in 1969. However, if we define the money supply, as I believe we should, to include U. S. Government deposits,

the figures would show a 1.6% rise in 1966 against only 1.1% in 1969.

To give you some other ten-month measures, time deposits at commercial banks were up 8.4% in 1966 and down 6.6% in 1969. The monetary base was up 3.3% in 1966 and up only 2.7% in 1969. Total bank reserves were up 1.6% in 1966 and down 3.0% in 1969. The average loan deposit ratio for the banking system as a whole was 66.8% in September 1966 and 70.6% in September 1969.

I think we can conclude from these numbers that, in general, the monetary policy of 1969 has been at least as restrictive, and possibly more restrictive, than the monetary policy of 1966. In only one area has its impact been less restrictive - - the residential mortgage market. This exception was by design rather than by accident. The Federal Reserve was given a mandate by the Congress to the effect that the tight money policy of 1969 should not impose the same crushing burden on residential construction that it imposed in 1966. By the use of Regulation Q ceilings, which has limited the ability of the commercial banks to bid money away from nonbank intermediaries, and by greatly increased government operations in the mortgage market, principally FNMA and the Federal Home Loan Bank system, this mandate has been fulfilled. In shielding, at least to some extent, the housing industry, monetary policy has necessarily put more pressure on other sectors of the economy, particularly on state and local governments and the municipal bond market.

How has the economy responded thus far in 1969 in comparison to 1966? I think there is a general feeling in the business community that the response to monetary policy has been considerably less in 1969. I am not convinced this assessment is warranted. We have, in fact, produced a greater slowdown in real economic activity thus far in 1969 than we could point to at the corresponding period of 1966. In the first three quarters of 1966, the GNP grew at an annual rate of 8.6%, which compares with 7.4% in 1969. Real GNP was up 4.9% in the first three quarters of 1966 vs. only 2.2% in 1969. The industrial production index was up at an annual rate of 8.4% in the first ten months of 1966 vs. only 3.3% in the corresponding months of 1969.

The statistics we have received thus far for October are reassuring. Industrial production is down for the third consecutive month, the average work week declined substantially, we received additional confirmation that the underlying trend in the unemployment rate is upward and that the rate of increase in personal incomes is slowing markedly.

I think there is every reason, therefore, to believe that we will generate a leveling off in economic activity in the first half of 1970. This leveling of activity, in an economy with a great growth potential, will produce both somewhat lower corporate profits and somewhat higher unemployment rates. These developments, in turn, will exert the marketplace discipline on both management and labor which is the essential requirement for greater price stability.

I have been appalled in recent weeks to discover the depth of support in the New England business and financial community for wage and price controls. I am amazed to think that the memories of businessmen and bankers are so short as to believe that we can find the answer to our inflation problem by abandoning the free market and turning over to a group of men in Washington the job of controlling specific wages and specific prices for a complex economy of 200 million people stretched 3,000 miles across a vast continent.

I feel strongly about this issue because I was one of the group of men who tried to control prices and wages during the Korean War. We had a goodly number of bright people devoted to the task and we worked very hard at it; but, looking back, I honestly do not believe we accomplished anything except to throw up an array of roadblocks to the efficient functioning of free markets. I left the Office of Price Stabilization in 1953 with the strong conviction that never, except under extreme national emergencies, should the United States ever again turn to wage and price controls as a means of attempting to combat inflation.

Probably 90% of the popular fallacies about monetary policy can be attributed to what the philosophers call the fallacy of composition - - that is, the error of thinking that what is true for the individual unit must also be true for a system composed of such units. The idea that monetary policy has failed because the larger banks have circumvented policy through such things as the issuance of commercial paper is a good example of the

fallacy of composition at work. It is true that if Bank A issues commercial paper, this gives Bank A more resources to lend, but this process does not generate any net increase in the total volume of resources available for investment in the system as a whole. The process of selling commercial paper does not generate more bank reserves, nor does it increase the money supply. What it does ^{do it} _^ it to increase the volume of credit flowing through the banking system at the expense of reducing the volume of credit provided by nonbank sources. It is a game of robbing Peter to pay Paul. In this game it is important to the individual bank whether it is playing the role of Peter or the role of Paul, but it is nonsense to believe that monetary policy is being subverted in the process.

The third fallacy which I propose to deal with is perhaps the most dangerous one - - the idea that, unless we are prepared to generate a real recession, we cannot hope to deal with inflation. It is a dangerous notion because it tends to reinforce the inflation psychology prevalent in the business community. The reasoning is as follows: (a) it will take a major recession to curb inflation, (b) the Federal Reserve and the Administration do not want to generate a major recession, ergo, (c) inflation will not be stopped. The thing that is wrong with this reasoning is the initial proposition that it will take a major recession to curb inflation.

The experience of 1967 demonstrates that, by taking the edge off the boom it is possible to slow down the rate of advance in prices without generating a massive increase in unemployment. If we look at what happened

to price behavior during that recent period, we find these facts. The wholesale price index for manufactured goods, which had been rising at a 3.5% annual rate during the first nine months of 1966, leveled off during the following three quarters. The consumer price index, which had been rising at a 3.6% annual rate during the first nine months of 1966 slowed down to a 2.2% annual rate of advance during the next three quarters. While this was going on, what was happening to the unemployment rate? It went up from 3.7% in September 1966 to 3.9% in June 1967. Those who had forecast a recession in 1967 on the basis of the tight money policy in 1966 called what happened then a mini-recession. In my judgment, this is straining the language.

I am not suggesting that history is going to repeat itself and that the first half of 1970 is going to be a carbon copy of the first half of 1967. This is highly unlikely. We face a more difficult inflation problem today than we did three years ago. The cost pressures are going to be much greater and the inflation psychology is very much more deeply rooted than it was at that time. However, I think the 1967 experience is useful in demonstrating that it is possible to dampen inflation without generating massive unemployment.

I think we often tend to overlook the fact that the greatest anti-inflationary force we have at our command is the tremendous growth potential of the economy of the United States. It is because of this great growth potential that a leveling off in economic activity will be enough to begin to generate substantial market forces working toward greater price stability.