Whither Inflation

Remarks of Mr. Robert P. Mayo
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I am pleased to have this opportunity to meet and renew acquaintances with many members of the Illinois Bankers Association. I am pleased too, to have this opportunity to share with you some of my thoughts on the current state of the economy.

In thinking about my remarks for today, I wondered what I might talk about that would be most interesting to a group concerned with the problems of bank management. Knowing that there would be many qualified management specialists on the program, I decided to be a generalist-- and to discuss the economic environment in which your management decisions are made. And at the risk (or perhaps the hope) of talking the problem to death, I have decided to concentrate on the issue of inflation-- that perplexing and at times seemingly intractable problem for our society.

It won't be difficult to be provocative. After all, there are a great number of irritants in today's environment. The economic situation is certainly one of them. The current economic climate may not necessarily provoke you to anger, but it surely is perplexing, Here we are as businessmen and policy makers looking on the one hand for clearer indications of cooling on the price front and yet on the other hand for signs of revival in the pace of economic activity. These two hoped for developments seem to conflict in the sense that they seem to require what appears to be contradictory policy prescriptions. To paraphrase that present day television commercial, we apparently are being told "what do you want--lower unemployment or lower prices."

As though that weren't enough we can't seem to decide what to call the economic developments of the past few months--a dip, a slide, a mini-recession, or what. Late last month it seemed that the National Bureau of Economic Research, which names such things, had decided to label this period a "growth recession." But I haven't seen anything more on this recently so perhaps someone just jumped the gun at those New York meetings. If the name isn't sticking, I sure am curious as to whether it is word "growth" that bothers them or the word "recession."

But whatever it may be called, the economy is obviously "doing its thing" as the young people would say. Money and security markets are going through some interest rate adjustments. Money supply figures and talk of easier monetary conditions are common business lunch conversations. Businessmen everywhere are trying to rationalize the dichotomy of rising prices with a plateau in real economic activity on a nationwide scale. And often the national statistics offer no comfort at all to businessmen in a city or an industry that is indeed in a recession--and there are many such examples today.

Let me add my voice to this discussion and talk with you about recent credit and monetary developments, inflation and policy.

The year 1970 to date has seen what amounts to an unwinding of monetary restraint. The second half of last year, you will recall, was a time of pronounced monetary tightness. From mid-1969 right through until the end of the year, the money stock showed almost no change. This had been preceded by a long period of rather lively money growth ever since monetary restraint in 1966--6 1/2 to 7 percent per year for more than two full years.

But since spring, definite steps have been taken to ease monetary and credit conditions. Total demand and time deposits have grown very rapidly, with most of the growth coming from expanded time deposits. The large banks have been able to attract large denomination certificates of deposit because rates on competing instruments moved lower and because the Board of Governors suspended the ceiling on the rates that banks could pay on large short-term CDs. In addition, there has been a substantial growth in consumer-type time deposits.

Since the end of 1969, the total money stock has grown at an annual rate of roughly 4.5 percent. Since last March, or through the past two quarters, the growth rate has been somewhat greater than this, or on the order of 4.7 percent. By historical standards, these are above average rates. Yet they have been generally consistent with and reflect the widely heralded turn toward easier monetary policy that took place shortly after the first of the year.

A more liberal supply of bank reserves and the accompanying expansion in bank credit has been reflected in the decline in money market rates. In late 1969, Federal funds sold for as high as 9.68 percent; on Monday the rate was 6 percent. The yield on Treasury bills was as high as 8 percent in late 1969; on Monday the rate was 5.77 percent. Moreover, the easier money market conditions and the increased availability of reserves have, on the average, reduced the borrowings of member banks from the Federal Reserve Banks.

Despite the decline in short-term interest rates the past months could hardly be regarded as a period of easy credit, <u>despite the climate</u>

<u>of monetary ease</u>. A voracious demand for long-term accommodation by corporate borrowers, a vigorous demand for funds on the part of the housing industry and state and local governments--plus frequent trips to the market by the Treasury and the federal agencies--have combined to sustain heavy pressure on overall credit supplies.

The September decline in the prime rate may be taken as a portent of further softening in interest rates in the closing months of 1970. At the same time the prospect of continued heavy credit demands affords little reason to suppose that any pronounced decline in longer term rates is in the offing for the near term.

The persistence of historically high interest rates (and both short and long term are historically high) is frequently noted as a reflection of the lingering presence of inflationary sentiment and inflationary expectations. It is argued that if borrowers and lenders had become generally convinced by now that the forces making for higher prices--especially in markets for durables, new construction and other long-life assets--had by now largely spent themselves, interest rates today would be appreciably lower than they are. In short, the mark-ups built into the interest rate structure as a hedge against inflation in recent years are still there.

The stubbornness with which inflationary psychology has clung attests to the dimensions of the task that has confronted monetary management--and for that matter, fiscal management--during the whole period since mid-1965, when the defense build-up got started. The continued existence of inflation after an extended application of counter-inflationary policy had left us in the awkward and rather paradoxical position of having to sustain the effort despite the emergence of signs that the policy in terms of wringing out excess demand was succeeding. No one would argue that the job has been accomplished. Prices continue to climb uncomfortably--albeit over the longer pull the rates of advance are moderating. Meanwhile, the pace of economic expansion has slowed.

But consistent with the "growth recession" label, the decline has been mild. Total employment, personal income, industrial production and overall output are all at, or near, all-time highs. Consumer outlays are growing. In fact, the overall economic adjustment since the summer of 1969 has been milder than in any recession since World War II. Even in comparison with the recession of 1960-61, considered in retrospect to be the mildest of the postwar period, the current adjustment is relatively modest.

Nevertheless, we are all aware of the weaknesses that confront the economy. Defense production has declined, the rate of growth of business capital spending has slowed and--most importantly--the labor markets have eased considerably.

The upshot is that we appear to be looking anxiously for signs of two things that are generally thought to be antithetical: for one, clearer indications than we have had thus far of cooling on the price front and second, signs of revival in the economy's pace of real activity.

As a rule, a lagging pace of real activity, which spells dwindling pressure on the economy's resources, can be construed as precisely the kind of environment in which to find weakness in the price structure, or at least lessened upward pressure. But an acceleration in the real economy is usually associated with a buildup of price pressures. To put it the other way around, a sustained uptrend in prices is something that we ordinarily expect to find when there are undue pressures on resources, not when there is slack. A sidewise price movement, not to mention an outright downturn, is the sort of thing we typically associated with a widening gap between production potential and production performance.

In the present environment, however, the uptrend in prices continues against the backdrop of indications that the economy's performance continues to slip progressively below its output potential. But this state of affairs is not really as paradoxical as it seems at first blush. The reason is that the forces behind any marked and sustained uptrend in prices take a considerable time to develop in the first place and then to spread through the economy.

Consider the sharp expansion in federal expenditures set in motion by the escalation in Viet Nam, heavier human resource spending at home, and the responsive accommodation of the Treasury's needs in the form of monetary expansion. It was not to be expected that these expansionary impulses would subside in short order after the initial impetus. Rather, the expansion touched off effects on income and expenditure that were to manifest themselves over an extended period, right down to and through the present, to judge by historical patterns. Moreover, it was scarcely to be expected that the steps initiated to battle the waves of excessive expansion after mid-1965 would quickly register.

As I have indicated, the sidewise movement in the Nation's money stock, and in bank credit, that characterized the second half of 1969 gave way to renewed growth of these important financial aggregates at the turn of the year. Ever since that time money expansion has continued, at a generally moderate and reasonably steady rate. If the time lag between the initiation of a change in monetary policy and the time of occurrence of the response to that change is on the order of six to nine months--as is suggested by certain of the empirical studies that have been made--the economy ought to be at a turning point just about now. Largely for the reasons that I have sketched here quite briefly, the expectation has become more widespread that the final months of this year--and more particularly the first half of next year--should see with the cessation of the GM strike more evidence of economic buoyancy. By the same token, the avoidance of excessive financial growth during the past three quarters, affords grounds for believing that the inflationary pressures with which we have been grappling are due to lose their strength.

In characterizing the thrust of monetary policy over the recent past, I have placed considerable reliance upon the behavior of money. In doing so I have not intended to suggest that any exclusive preoccupation with this monetary variable is necessarily appropriate as a matter of principle. Important as the money stock is, it constitutes only one variable with which the central bank needs to be concerned.

A mechanical application of monetary rules is, of course, unrealistic. The Federal Reserve System obviously cannot ignore the sharp shifts in money and credit markets--nor has it. Both open market operations and the discount window were used constructively this year to accommodate credit demands of the banking system. In addition, once it became apparent that some nonbanking firms were having difficulty in refinancing commercial paper, the Board suspended Regulation Q ceilings on large denomination certificates of deposit with maturities of less than 90 days. This enabled banks to obtain funds that investors were hesitant to place in other markets and to rechannel these funds to borrowers previously dependent on commercial paper.

Remember that the economy has experienced some unusual stresses and strains this year. Economic policy has had to walk a tight rope. But it has, I feel, largely done an excellent job.

The task cut out for the Federal Reserve at a time like the present is obviously a delicate one. The price of deviating significantly from a course that is appropriate under the circumstances could be considerably higher.

We are now beginning to reap in the form of reduced inflationary pressures the rewards of the restrictive fiscal and monetary policies of 1969 that have slowed down the pace of the economy. Progress has been slow; but if these developments are given a chance to continue, the inflationary situation should be much better in the future than it appears to be now. I do not believe that we will have inflation forever.

Nevertheless, when we ask businessmen and bankers if they expect inflation to continue or if the persons with whom they normally come in contact expect it, the most frequent answer we get is "Yes." Ordinarily they point to the high wage settlements that are being negotiated through collective bargaining agreements. Although most businessmen recognize that such wage settlements do not apply to a relatively large number of workers, they see in them evidence that costs will continue to rise and that higher prices are inevitable.

Yet there is a difference between what some businessmen say and what they do. Strong inflationary expectations have, in the past, helped explain the acceptance of high interest rates and continued plans for capital investment despite current unused capacity. If prices are going to keep on going up forever, why postpone expenditures?

The latest information on planned plant and equipment expenditures obtained in the joint Commerce Department and Securities and Exchange Commission survey suggests that many manufacturers are having second thoughts about the likelihood of inflation forever. Lower sales and profits are having an impact on their plans. So is the increasing burden of recent debt financing.

The performance of profits in the immediate past is one of the factors considered in planning for the future. When American manufacturing corporations were planning their plant and equipment expenditures during the first quarter of 1970, they had figures on their profits for the last quarter of 1969 to help in their planning. During the fourth quarter, profits totaled $8.4 billion. This figure undoubtedly had some influence on the plans to increase capital spending by 9.9 percent from 1969 to 1970.

When it was time to take another look at their plans, first-quarter 1970 profit figures were down considerably from those of the last quarter of 1969. Perhaps this was one of the reasons why plans for 1970 were revised down from a 9.9 percent increase to 3.7 percent. The second-quarter profits figures that were available when plans were reviewed again in the third quarter of 1970 were somewhat better than those of the first quarter of 1970; but when the seasonal rise that is generally expected is considered, there was little change. Plans were revised down once again, this time down to a 1.2 percent increase. The businessmen who were making these plans did not act as though they expected inflation forever.

Undoubtedly inflationary expectations persist and their persistence delays deflationary adjustments. Nevertheless, I believe we will see more and more examples of actions that demonstrate doubts about inflation continuing forever.

Our economic system is working as we had expected it to work in abating inflationary pressures. If we let it continue to work, the most likely outcome will be further progress in getting inflation under control.

Too tight a constraint on financial expansion could mean underuse of our economic potential, widening joblessness, and output and income forever lost. However appealing it may be to tackle inflation even more forthrightly, by tightening up on growth in the money stock or on bank credit--or, conceivably, on interest rates--in order to curtail credit-supported spending the cost of such a move in real terms could be, and, I submit, probably would be excessively high.

On the other hand, we can have inflation forever without working hard at it at all. A move toward greater monetary ease and lower interest rates, out of say, over concern with the effect of tight credit on housing or on the state and local governments, would all but inevitably set the stage for another bout with inflation sometime later on--and it would likely be sooner rather than later. Responsible monetary management in today's setting means adherence to a path of steady and moderate growth.

Impatience may well be our greatest danger. Getting inflation under control is a slow and, to some extent, a painful process. There is the constant temptation to conclude that, since the process has been so slow, it will never accomplish the task. Under these conditions, there is an ever-present temptation to the Administration, to businessmen, and indeed to the monetary policy-makers to relax before the task has been completed.

Inflation is not a necessary attribute of our economy. I believe that the performance of the Federal Reserve during the year so far has been consistent with an objective of steady and moderate growth and I am confident that we will be able to stay on such a course in the months ahead.