Statement by Mr. Robert P. Mayo, President,
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to the Committee on Banking and Currency,
U. S. House of Representatives, Washington, D. C.,
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I am pleased to have the opportunity to meet with you today to do whatever I can to assist your Committee's inquiry into the problem of inflation in our national economy. We all agree that inflation and its attendant effects on interest rates, asset values, real incomes, and the general welfare of our citizens are indeed serious. Those of us in the Federal Reserve System share with the Congress and the Administration the desire and the responsibility to achieve our national goals of high employment, relatively stable prices, sound economic growth, and a reasonable balance in international payments. I think it is crystal clear that the Federal Reserve System is not only fully aware of the dangers and costs of continuing inflation, but is making every reasonable effort to resist and contain the current rising trend in the general price level.

In our present unusual economic environment, this is not an easy task. But the task would be even more difficult if the Federal Reserve System, as the manager of the nation's monetary system, did not possess a strong regional orientation and structure. Since I assumed my position as President of the Federal Reserve Bank of Chicago almost four years ago, I have found the economic input from the members of my Board of Directors most helpful as I have attempted to evaluate policy alternatives in an environment in which our national economic intelligence--even though the best in the world--is still inadequate. The existence of this strong regional structure, in my view, permits the Federal Reserve to be more flexible and responsive to a rapidly-changing economic environment that is only reflected in more formalized data with a significant time lag.

I can also report to you that the degree of public support in the Seventh Federal Reserve District for current Federal Reserve monetary policies is very strong, judging by the comments I have received wherever I go. The encouragement for continued monetary restraint comes not only from the banks but also from institutions and individuals whose own financial condition often has been and will continue to be adversely affected by continued market pressures. The public is fed up with inflation. They have finally decided that price rises have gone beyond the tolerable level. They are willing, I believe, to support effective efforts to control inflation--recognizing that there will be substantial costs involved in so doing.

I am gratified by this support. Without it we might become less confident in our resolution to accomplish the difficult task that lies ahead. Yet we must always remember that excessive zeal in combatting inflation could lead to even more serious economic difficulties than those that now confront us. The current inflation has developed over a long time. It is worldwide--not just a U. S. phenomenon. But as leaders of the free world we have inflation control responsibilities that extend far beyond our own borders. It will take time, determination, and patience to resolve these problems.

As we choose the course to follow in combatting inflation wisely, we must keep two important factors in mind--the sequence of events that has led us to our current situation and, exactly where we stand at this juncture. A brief review of the past provides us with a better understanding of earlier misjudgments that should be avoided in future actions. Knowledge of the current situation is essential because the U. S. economy responds only gradually over time to the majority of forces leading to change.

Therefore, we must take into account forces already set in motion that are not as yet evident. There is no such thing as instant monetary policy. Its lag is variable and not precisely predictable.

No one will deny that inflation is concerned with the relationship between the quantity of goods and the quantity of money. But that relationship in turn has many facets. The great perspective of 2020 hindsight tells me that the growth of the money supply during 1972 and the first part of 1973 was somewhat higher than many of us wished in view of the way the underlying economic situation turned out, thus adding to some degree to inflationary pressures.

But even more importantly, we cannot ignore the fact that many other factors outside the influence of the Federal Reserve played a very important role in the unprecedented inflation of 1973-74. Those factors include the coincident strong expansion of all of the industrialized nations of the world, crop failures abroad, successive devaluations of the dollar, and the termination of the wage-price control program which was necessary, at least in its early stages, to help mitigate the effects of our deficit-riddled fiscal policy of 1967 and 1968. All of these events together produced 1973 export demand far exceeding expectations, and added price pressures to a domestic economy already operating at full capacity or beyond. Finally, of course, the oil embargo was an obvious unanticipated shock, and the substantial price impact domestically was equally unnerving.

In addition to these special factors, hopefully non-recurring--fiscal policy, in terms of budget deficits, became too expansionary in 1971 and 1972 as the federal government worried more about large potential increases in unemployment (which did not develop) than about large increases in inflation (which did). The Federal Reserve has an independent charge from the Congress to act as a prudent manager of monetary policy. But the

Fed is also charged with responsibility for maintaining an effective, viable financial system--not just fighting inflation blindly regardless of the consequences. When the Administration recommends--and the Congress authorizes--expenditures far in excess of revenues, the Treasury has no alternative but to issue more securities to pay for its spending. The Federal Reserve has, of course, a responsibility to see that the Treasury is successful in acquiring the necessary funds without significant distortion and disruption in financial markets.

When excess capacity exists in the economy, and the money and capital markets are quiet, the Treasury can handle deficit financing and refund maturing issues fairly easily. But, as the economy approaches capacity output and the deficits persist because of fiscal policy lags, the Treasury must compete with other market participants for increasingly scarce financial resources. Under these circumstances, continued large Treasury financings, particularly with an ever shortening debt maturity structure, can have significant impacts on market interest rates. In order to avoid serious disruptions in private capital markets, then, the Federal Reserve is under pressure to allow more rapid increases in monetary aggregates than would be the case in the absence of debt management pressures. The net result of assisting deficit financing in an economy which has already generated sufficient momentum to achieve very high employment levels is, of course, inflation.

The Congress has not, of course, intentionally placed this burden on the Treasury and the Federal Reserve. It is a residual burden--albeit a heavy one. Rather, my experience as a Treasury debt management official, as Director of the Bureau of the Budget, and as a Federal Reserve Bank president, indicates to me that this situation arises from a fundamental flaw in governmental coordination of economic policy and public finance up until the present time. There is great need for a system to review all of the authorizations of the Congress and their spending implications in totality, taking into account the impacts of these actions not only in specific areas but also on financial markets and the growth of economic activity in general.

I testified a year ago before the Congressional budget reform committee as a strong proponent of the proposal that the Congress establish a Joint Committee on the Budget to provide the Congress with an independent view of the whole budgetary picture, and with an analytical staff capability of its own to lessen its factual dependence on the Executive Branch. I am most enthusiastic about your recent approval of such overall fiscal control. The cynics say it won't work because of the deep-seated jealousies of Congressional committees. I disagree. It can work and I believe Congressional leaders will see to it that it does.

I now turn my attention to a few key issues in our current environment. We know that once the economy is operating close to full capacity, monetary growth in excess of the growth of the capacity to produce goods and services will sustain general price inflation and will result in higher interest rates as ongoing rates of inflation are built into those rates. In such a situation, we must ask why the rate of inflation, and interest rates, cannot be decreased simply by reducing the rate of monetary growth.

The answer lies in the fact that, as a nation, we have more than one economic goal. In addition to our desire and need to reduce the rate of increase of the general price level, we must consider the effects of any contemplated restrictive actions on unemployment and on overall economic growth. And, we must be cognizant of the sectoral ramifications of various degrees of constraint--the housing sector being the most obvious example currently, as it was in 1966 and 1969. Nor can we neglect the needs of small businesses and our local governments. Finally, we must always remind ourselves that any actions we do take will have their principal effects not today, but some months hence. We should not expect immediate price restraint from restrictive actions. We also must take great care that we do not overstay whatever restriction is adopted and precipitate a serious economic downturn. The problem is made even more difficult by the limited ability to forecast future economic developments.

The tradeoff relationship that exists between the rate of general price increase and the rate of unemployment is unstable and is therefore of limited usefulness as a guiding principle of economic policy. Nevertheless, the relationship cannot be ignored as we assess the alternatives open to us at any time. A restrictive monetary policy can result in increased unemployment far more quickly than it can result in decreased inflation. And we know that the expectations of consumers, businessmen, government officials, and financial market participants play a critical role in a situation of persistent inflation. These expectations are affected primarily by performance--not by promises--and even then very slowly. We must move cautiously yet firmly with our restrictive actions and be prepared to adhere to those policies long enough for the effects to be felt.

A reduction in the rate of inflation--and in price level expectations--will eventually produce a decline in interest rates. But this result will occur only after an appreciable lag. When economic activity is stimulated to a point where the rate of output in dollars exceeds real capacity output, the initial response of interest rates to the adoption of a restrictive monetary policy will be <u>increased</u> rather than <u>decreased</u> interest rates. This is true because real money balances tend to be reduced below desired levels within our existing income and price structure. Given our reliance on general monetary and fiscal restraint, declining interest rates will occur only after aggregate demand is reduced, thereby reducing demands for money and credit. As prices respond, the rate of inflation will then subside and expectations of inflation will be reduced. It is only then that the inflation premium in interest rates will be eroded--not before.

We have seen a good example of the shorter-run relationship between restraint in monetary growth and market interest rates during the past six months or so. During this period, the U. S. economy suffered from inflation stemming from (1) past fiscal and monetary stimulus, (2) relaxation--and then termination--of a wage-price control program that had overstayed its welcome and its usefulness, (3) the effects of shortages in energy and agricultural products, and (4) international developments. When it became clear that the Federal Reserve was moving further to restrain these inflationary forces, interest rates, as you all know so well, increased rapidly. Demands for money and credit far exceeded expectations which reflected in part the sharper than anticipated rate of general price increases.

Market interest rates have increased so far and so fast this year in response to our efforts to restrict availability of funds to banks that new questions have arisen about the operations of our nation's financial markets. The economy has been subjected to a highly unusual shock by the arbitrary and very sudden increases in petroleum prices. Underwriting these price increases fully by monetary expansion is, of course, self-defeating if the monetary expansion simply results in further price increases. But there is much more to it than that.

Increases in energy prices of the magnitude we have witnessed require reallocation of real consumer and business spending throughout our economy. Spending patterns will either shift toward more dollars spent on energy, away from other areas or there will be a reduction of energy use--or some combination of the two will occur. In a textbook economy that adjusts instantaneously to rapid and large changes in relative prices, such a reorientation could take place without undue strain. But the economy of this country does not adapt that quickly to changes of such magnitude. Thus, insistence that increases in energy prices be treated as relative price changes that should not be permitted to increase the general price level at all runs the serious risk of an economic downturn. It seems preferable to me to permit a portion (but as little as is reasonable) of these non-recurring price increases to be reflected in increases in the general price level in order to provide additional time for adjustment to the new environment. On both of these grounds--minimizing financial market adjustment problems and adapting carefully to the sudden changes in energy prices--and the aftermath of the 1973 upsurge in agricultural prices as well--I believe monetary aggregate growth modestly in excess of what might be considered "normal" guidelines in recent months is appropriate.

We are sailing on uncharted seas. Our 1974 economic environment is a new experience in terms of supply constraints. Reliance on past patterns and relationships as a guide to policy making and policy execution has been less than adequate. Therefore, we are still operating in a highly unpredictable environment, one in which the broad outlines of an unfolding situation are only now becoming a little clearer. Here again I am thankful for the role that our regional Federal Reserve bank board of directors play in helping us clear away some of the clouds of uncertainty.

Under these circumstances, an <u>overly</u> protective or timid appraisal of the ability of financial markets to withstand strain, or an <u>excessive</u> accommodation of highly unusual price increases, would have the effect of worsening inflation. And, throughout our discussion, we must bear in mind that the sharp increases we have seen in key prices are only beginning to appear in their secondary effects on prices of other products--and in wages.

We do not have the ability to perform miracles. We have no magic wands to wave. Our own analysis of economic developments during the second quarter of 1974 indicates that we have passed through the critical period of serious petroleum shortage reasonably well, all things considered. Unemployment did not increase significantly and our economic decline seems to have leveled off. Yet we are just now facing what in many ways is the more serious phase of the problem. Inflation continues and will accelerate in many areas in response to earlier price increases in key commodities. Markets remain unsettled. Uncertainty is still a major factor.

While the current situation may seem to present only limited grounds for optimism, I believe we now have the opportunity to reduce our inflationary problem without imposing unacceptably high social costs in human misery and foregone output. The downturn in the first quarter was not accompanied by a large increase in unemployment, and pressure to be fiscally expansive in order to reduce unemployment has not been strong. There is some promise of relief from price pressures in the agricultural area in the coming months. Petroleum products are at least available once again even though prices are high. Finally, viewed against the background of recent price performance, monetary policy has already set in place restraining forces that will act as a brake on inflation and interest rates over the months ahead.

In conclusion, I want to remind all of us that we as a nation cannot reasonably expect to eradicate inflation during the next two or three years. If our policies are successful, they will be successful only in reducing the <u>rate</u> of inflation gradually. Nor should we as a nation ask <u>monetary</u> policy to carry the entire burden of inflation control. The social costs and adverse sectoral impacts of relying on a single general type of policy are simply excessive. It is absolutely essential that both specific and general <u>fiscal</u> policy measures be coordinated with monetary policy during the coming period if we are to truly dampen inflation.