Economic Diagnosis and Monetary Policy Prescription

Remarks of Mr. Robert P. Mayo
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I am particularly pleased to have this opportunity to meet with you tonight to discuss the role of monetary policy in the current economic environment. Even after the extensive discussion of economic policy options emanating from the recent "inflation summit" meetings, I feel that much of recent discussion of monetary policy has not been cast in the proper perspective. Given the unusually large number of swift cross-currents that exist in the economy today, this is perhaps not surprising. Tonight, I hope to be able to clarify some of the more important issues as we meet together.

I can't recall a period when monetary policy has received so much attention on television and in the press. And, there haven't been many times when the Federal Reserve has been confronted with such a wide diversity of opinion concerning what it did right or wrong in the past, how it should be acting now, and what its future policies should be. This reflects, I think, the concern and sense of frustration felt by so many over the difficulty of reducing the current rate of inflation to a more tolerable level. Many appear to be searching for a new solution--a simple answer. Unfortunately, there isn't any.

During the course of the year, the prediction of some analysts that the oil embargo would result in sharply accelerating unemployment early in the year was not borne out. Indeed, unemployment has increased from the March 1973 low of 4.6 percent to 5.5 percent a couple of months ago, only recently rising to 6.0 percent. But even the current 6.0 percent is below many early projections, and the increase occurred more gradually and later than many analysts thought. Prices, on the other hand, have risen during the course of the year considerably in excess of most early projections, and little evidence exists at this time that substantial improvement will take place in the near future.

And now, midway through the fourth quarter of the year, it is time for us to pay increased attention to the possibility that the emerging weakness in the economy might deepen into a serious recession, with little in the way of accelerated progress on the price front to show for it. In my opinion, there is no need for the current weakness in the economy to grow cumulatively worse, although some industries will undoubtedly be hit harder. And I believe that sufficient general restraint has already been placed on the economy to guarantee progress on inflation in the coming months. Because of the intensity and causes of our current inflation, we should not expect rapid progress in reducing the rate of inflation unless we are prepared to bear what I would judge to be excessive social costs.

Current economic policy decisions are dominated by the desire to reduce the rate of inflation without producing overwhelming costs in the form of foregone output or unemployment. It is also recognized that account must be taken of the sectoral impacts of any actions that are taken. Finally, it is necessary to see to it that the policies adopted can reasonably be expected to set in place conditions conducive to the resumption of orderly economic growth with reasonable price stability rather than set the stage for another unsustainable boom, followed by renewed inflationary pressures.

Monetary policy formulation cannot and does not escape from this difficult and perplexing decision environment. It is the interplay of these factors that makes the current situation so frustrating, so uncertain, and so difficult to comprehend. Tonight, let me give you some guides to thinking about the role and operation of monetary policy that might be helpful to you as you attempt to interpret unfolding events.

The factors playing a role in the rapid inflation of 1973-74 have been noted widely. They include the coincident rapid expansion of all the industrialized nations of the world, increased demands for a better life by the world's developing nations, crop failures abroad, successive devaluations of the dollar, and the termination of a U. S. wage-price control program which in its latter phases did more harm than good. These events produced 1973 agricultural export demands far exceeding expectations, as well as increases in other exports and rising import prices. They added pressures to an economy already operating near full capacity. And then the oil embargo occurred with its unnerving price increases and its unpredictable potential real output impacts.

With the perspective of 20-20 hindsight, it seems to me that monetary policy also added to inflationary pressures. The growth of the money supply during 1972 and the first half of 1973 was higher than many of us wished in view of the way the underlying economic situation turned out. I would note, however, that the general expectation before the oil embargo began was for an easing of the pressures on productive capacity in 1974 after monetary policy became much more restrictive in the second half of 1973.

And fiscal policy was certainly a significant factor that increased inflationary pressures. In terms of budget deficits, fiscal policy was far too expansionary in 1971 and 1972. Whenever the Administration recommends--and the Congress authorizes--expenditures in excess of revenues, the Treasury has no alternative but to issue more securities to pay for the expenditures. The Federal Reserve, charged with the responsibility of maintaining an effective, viable financial system--as well as being a prudent manager of monetary policy-cannot ignore the responsibility to see that the Treasury is successful in acquiring necessary funds without significant distortion and disruption of financial markets. Under these circumstances, the Fed is under pressure to allow more rapid increases in money supply than would be the case in the absence of such debt management demands. In an economy that has already generated sufficient momentum to achieve very high employment and output levels, the net result is inflation.

In assessing alternative economic policies-whether monetary or fiscal--we must keep in mind that events in the past continue to affect the present and will influence the future as well. The slate cannot be wiped clean. We must start with where we are and be very much aware as to how we arrived there. Because the U. S. economy responds only gradually over time to the majority of forces leading to change, we must take into account forces already set in motion even if their effects are not yet fully apparent.

In the current context, many have argued that since we have had a restrictive monetary policy during this past year--particularly since last spring--the rate of inflation should have been curbed--some would say markedly. Because this has not occurred, should we conclude that monetary policy has not been restrictive enough? Or that traditional policies no longer work? Or is it because we are looking for unrealistically rapid responses?

I think we have been restrictive enough. In fact, it would have been far better if a less restrictive monetary policy could have been coupled with a more restrictive fiscal policy in order to avoid undesirable disproportionate sectoral effects--on the housing industry, for example. Further, I refuse to accept the argument that traditional policies no longer "work." I conclude, therefore, that we are too impatient in looking for immediate results.

We know that lags exist, that they are variable, and that they are not precisely measurable after the fact, much less predictable with any degree of accuracy. We know too that 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 or rhetoric--and even then slowly, according to past experience. Unfortunately, in the current situation the response may be even slower because of the experience since the mid-1960s with what appears to be successively more difficult bouts with successively more stubborn inflationary periods.

These lagged responses to policy actions pose a dilemma for current policy decisions. On the one hand, great care must be taken not to adhere to a tightly restrictive policy until distinct progress in curbing inflation is obvious. Because restrictive policies can generate increased unemployment far more quickly than price reponses, such a course would be wholly to generate a serious economic downturn. And it would give rise to strong demands for a shift to an expansive policy, possibly coupled with renewed wage-price controls. In my view, such an outcome would forfeit the anti-inflation benefits that are already set in motion by restrictive policies to date.

On the other hand, care must be taken not to overreact to the currently unfolding evidence of weakness in the economy by relaxing restrictive monetary policies by too much too soon. Such a response would also detract from the effects of the counter-inflationary policies that have already been carried out. Further, the current weakening in the economy was widely projected as a concomitant of efforts to restrain inflation. Short of wage and price controls--which I think have limited usefulness in a democracy--there is no known way of avoiding this side effect of combating inflation.

I continue to believe that our greatest economic concern today should be the reduction of the rate of inflation. But I am aware of the position of those who argue that the costs (in terms of foregone output and unemployment) of combating inflation exceed the benefits to be derived. And for this reason, I have been somewhat dismayed at the reception the President's recent proposals have received. Everyone is against inflation in general. Only a few appreciate the sacrifices necessary to conquer it.

Specifics aside, I believe the President's short-range proposals afford a way of simultaneously fighting inflation, alleviating disproportionate imposition of burdens on selected sectors, and encouraging a continuation or expansion of much needed capital investment. If these or similar proposals were adopted, the costs of inflation would be spread more evenly across the economy while providing some assurance that a resumption of economic growth could proceed in an orderly fashion after a year or so of reduced economic activity. Inflation cannot be stopped completely in such a short period, but it is likely that it could be reduced to more tolerable levels.

What I have been discussing here may appear to be very obvious. But much of the analysis I see of current policy does not seem to grasp these points. Frequently, today's policies are evaluated in terms of what exists in the economy today. I find this particularly true with respect to monetary policy. Far too often, assessments of monetary policy are based on the most recent behavior of currency and demand deposits--or what is usually referred to as M_1.

My remarks thus far have focused on the important role of lags in the impacts of policy actions on economic activity, and on the existence of competing, sometimes conflicting, economic goals. Against this background, I would like to turn now to a brief discussion of the reason why the use of M_1--particularly current figures on M_1--as a measure of monetary policy must be used with great caution.

I raise the issue of M_1 not to deny the notion of a causal connection between the behavior of the money supply and the behavior of economic activity. On the contrary, that is a perfectly respectable view, with many supporters and a good deal of evidence to support it. I do feel that there is more confusion than necessary about the extent to which this concept enters into monetary policy deliberations and about the ability of the Federal Reserve--even if it desired to do so--to hit a specific money supply target over the very short run.

With respect to the first of these points, I can assure you that the behavior of M_1 (and other monetary aggregates) is taken into account very seriously in Fed policy deliberations. I should also indicate, however, that the view that monetary growth should occur at an invariant rate is not accepted. Other factors that imply discretionary use of monetary policy and varying rates of monetary growth also weigh heavily in the policy-making process.

With respect to the second point--the Fed's ability to control the money stock--several factors should be noted. It is well known that the ultimate goals of monetary policy involve the behavior of employment, prices, economic growth, and international trade and payments. Monetary policy does not affect these goals directly with sufficient speed for purposes of making policy decisions.

For this reason, the Federal Reserve relies upon intermediate goals that can be achieved more directly and relatively quickly. These intermediate goals, M_1 and other monetary supply aggregates, were chosen on the grounds that sufficient evidence exists of a predictable relationship between the aggregates and the ultimate goals to permit achieving the latter by means of targeting intermediate variables.

However, the intermediate targets are not under the direct control of the Federal Reserve either. Consequently, for operational purposes, a means of achieving the intermediate objectives by means of operational targets must be provided for the Manager of the System Open Market Account in New York. These operational, short-run targets must be related closely to the intermediate objectives and information about their behavior must be known quickly by the manager.

Currently, the operating target employed by the Federal Open Market Committee in setting its monthly policy goals is reserves against private nonbank deposits--RPDs. Nevertheless, the manager of the New York trading desk is not simply instructed to achieve a certain path for RPDs. Both in order to provide better control over the intermediate targets and to avoid undesired fluctuations in money market conditions, the federal funds rate also enters into the manager's trading operations.

Therefore, there exists a hierarchy of goals that the Federal Reserve pursues on a continuing basis. And at each level, there are errors in projecting the relationships between the targets as well as difficulties in acquiring accurate information about the behavior of the relevant variables. The result is that, in general, the shorter the time period, the less precise is the ability of the Federal Reserve to achieve its targets.

Given this degree of complexity, it is no wonder that observers can on occasion be confused in their perceptions of monetary policy. Nevertheless, I hope I have been able to convey a feeling of the reasons why it is inadequate to base judgments about monetary policy on short-term movements in M_1 alone.

The period ahead will not be easy. The recent inflation summit conferences disclosed that there is not much common ground on policy prescriptions and they made very clear the vast array of special needs and special interests which must be taken into account in reaching final decisions.

I earnestly hope, however, that we will not continue to rely almost exclusively on monetary policy alone to carry the entire burden of controlling inflation. The social costs, inequities, and adverse sectoral impacts of relying on a single general type of policy are simply excessive. Specific and general fiscal policy measures must be coordinated with monetary policy if we are to dampen inflation and resume more orderly economic conditions. And wage price-controls offer no solution.

Despite our problems of inflation and unemployment--problems shared by the entire western world--we have the basic economic strength to overcome them. I am as sure as I'm standing here tonight that we will emerge--given the sacrifices we as a nation must make--as the strongest and most economically sound nation in the world.