From tape -
Extemporaneous remarks

Informal Remarks of Mr. Robert P. Mayo
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I'd like to begin today by telling you about some of the problems associated with the dual challenges of fighting recession and fighting inflation as we see them at the Federal Reserve. Make no bones about it, we are trying to meet both challenges at the same time. It is difficult because with the path getting wider and wider, it is harder and harder to steer the middle course.

After I've outlined these difficulties and problems, the panel, as your chairman suggested, will be glad to entertain questions.

The tools the Federal Government has to help moderate inflation and moderate recession seem somewhat limited at times like this when you are trying to achieve both goals simultaneously. We all have the same goals in mind whether we are at the Federal Reserve working with monetary or credit policy or at the Treasury, the Budget Bureau or on Capitol Hill working with fiscal policy. Fiscal policy, as you all know, is merely a summary title for taxes and tax policy on one side and expenditures and expenditure policies of the Federal Government on the other. If fiscal policy acts to increase expenditures so as to moderate recession, a deficit can and typically does occur. This deficit has to be financed by the sale of securities in the market in competition with other securities issued by those at the state or local government level or others in the private sector who want to increase their indebtedness in order to expand their spending. To the extent that money isn't

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freely available to meet all these credit needs, the Federal Reserve may have to end up helping to finance Uncle Sam to some extent but this, in turn, might make the inflation fight more difficult.

I've been on both sides of this fence, and have sympathy for both the fiscal and monetary problems associated with achieving economic stability. Since the mid-1960s--a period of almost ten years now--we have had a period of inflation that has never really been fully under control. We only had about 1-1/2% inflation in the first half of the 1960s, but we also had about 5-1/2% unemployment so even then we didn't have a perfect result.

People dislike any inflation, seeking a zero rate--which is in my book pretty much impossible; but they also want to get unemployment down. Well, we did get unemployment down in the last half of the '60s; but we did it with almost a collision of Johnson administration great society expenditures for worthy causes (although sometimes the way in which it was done left something to be desired) and the Viet Nam War. The concurrence of those two factors produced Federal deficits that were huge. There were hopes that the Viet Nam War would somehow go away, but it didn't.

During much of the period, there was lingering hope that deficits could be reduced without the burden of additional taxation through the legislative route. Congress and the Administration didn't face up to the issue until mid-1968 and even then the Congress was very reluctant to pass taxes. So in the absence of tax legislation, we reverted to what might be called inflation legislation.

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In other words, the burdens of financing these expenditures were distributed through the varying effects of inflation, rather than through a more equitably desirable tax system. Thus, the burdens were borne, but they were distributed in very uneven ways. On the monetary side, the Federal Reserve was fairly restrictive around 1965. When the tax increase finally did pass, in 1968, the Fed eased, fearing that there might be fiscal "overkill". As a result, some of the benefits of that tax increase were lost. We had a tighter fiscal and monetary policy in '69 and again in the first part of '70 and in the process of getting inflation in better control, there was a softening of the economy in 1970. The downturn was short lived but it was still a recession.

Subsequently, there was a resumption of inflationary tendencies prompting the President in August of '71 to put a freeze on prices and wages and then to put in place a price and wage controls program for a couple of years. The effort started off all right, but in a period when there is slack in the economy, there isn't much problem in making such programs work. But when they were really needed, they didn't work. In other words, as inflation speeded up again, as the economy neared full employment in '72, it was much more difficult to adhere to price and wage controls. Prices burst their bounds just as they did when President Johnson tried guideposts and guidelines in the mid-60s.

On top of everything else, as you know, we had the oil embargo. We had the quadrupling of oil prices. We had crop failures

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around the world and there were dramatic rises in food prices.

The problem of inflation is worldwide; it isn't occurring just in the United States. Unfortunately, we can't hide behind the fact that this is a worldwide phenomenon, internationally oriented. The United States is still the largest resource-rich and most productive country in the world and our leadership is terribly important. If we can't turn off inflation, other countries have even less chance to do so. We have to take a leadership role.

Inflation resulting from these kinds of special factors set a difficult environment for monetary and fiscal policy. The longer run solution required an increase in supply but the opportunities for increases in our capacity could also be cut off by too restrictive monetary and fiscal policies. So we had to be careful with our policies.

Interest rates set new highs, as you know, in July and August of this year. They have subsided somewhat now. We have had expansion of the money supply during the past four or five months that is well below what you might call a desirable long term target. Indeed, the expansion of the money supply as defined by currency and checking accounts in the hands of the public has only gone up by about 5% this year as against, say, 6% in 1973 and 8% in 1972 and, indeed, as against a 12% rise in prices. So we have not validated even half, really, of the rise in prices that is taking place this year.

Now, having tried to describe where we are, I thought I might flip back to some of the fundamentals to try to give you, at

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least in my words, what I think these tools really mean. The Fed was created by Congress, just like the executive branch of the Government. We follow the objectives of the Employment Act of 1946 as does the rest of the government. In other words, we strive to maintain policies which will lead to economic growth with a minimum of inflation and with a reasonable balance of our international accounts. We are in a little different position, though, than Treasury, Commerce, Internal Revenue, etc., in that we are an independent agency. But we are independent <u>within</u>, not independent <u>of</u> the Government because we do share the same goals and we do work closely together in terms of policy formulation.

Our job is to try to make enough money available to keep the machinery of the economy going in a sound fashion. If you want to call it the oil that makes the machinery work, that's all right, although the word oil has all sorts of connotations these days. We do this, of course, by influencing bank credit. Three-quarters of the banks in the United States in terms of assets are members of the Federal Reserve. It isn't three-quarters in numbers; we have more than 14,000 banks in this country and only about two-fifths of them in terms of numbers are members of the Fed.

Member banks of the Federal Reserve System are required to keep reserves with the Federal Reserve Banks. It is through these reserves that we influence the amount of money and credit in the economy. We do not print "greenbacks" as you hear occasionally, but provide the basis for the creation of money. If because of economic conditions, we think the economy needs more money or credit,

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we will buy Government securities from the public and the banks. This purchase ends up providing the banks with more reserves with us. With more reserves, they can loan more and when they loan, the borrower has an increased amount in his checking account. That's where the printing of money in the colloquial sense takes place--at the banks.

So by buying Government securites through our New York open market desk, we can increase the money supply, but by selling Government securities, we can and in fact do pinch the banks and restrict their credit extension and money growth. We can also raise or lower reserve requirements or change the rate of interest charged on loans made by us to member banks. We did this as recently as yesterday.

This is a complicated mechanism, and I'm not going to get into all of the details because I think it would probably turn you off. I do, however, plan to give each of you a little booklet on money mechanics that you might find interesting to read as part of your "homework", if I may use the term.

Now, only the member banks have reserves with the Federal Reserve System. But this is three-quarters of the United States' banking "universe"; the commercial banking universe. The rest of our influence is sort of a billiard ball effect. Making things tighter for the commercial banks spills over to making credit tighter in the savings and loan associations, in the credit unions, in the commercial paper market and so forth. In various other ways it affects the insurance industry; it affects indeed all parts of the

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financial community. But it only affects it after some delay. And indeed it will even take awhile to affect the total bank lending situation.

There may also be an "announcement effect" of the actions we have taken. Our actions are interpreted in the weekly summaries you see every Friday as to what the Fed has been doing in the preceding week. But those usually represent an over-simplification of what we have been doing. There are an awful lot of occurrences that affect money market psychology. These are all mixed in with our actions, making it no easier to explain satisfactorily or completely what has happened than it is to explain why the stock market goes up one day and down the next when the news is basically the same.

So we have to evaluate our performance and ask others to evaluate us over a much longer period, as to whether the money supply is growing too rapidly or is indeed growing too slowly. If the money supply grows too slowly, you know what happens. It indeed does produce a recessionary period. A recession is not desirable in its own right; I think that is abundantly clear. Unfortunately, however, a recession often accompanies attempts to cool off price pressures since economic policy is directed toward reducing the demand for many of the products that we are used to. Through the free market mechanism, the lowering of demand leads to lower prices.

Reliance on the free market mechanism may seem difficult at times but it is particularly critical in the period that we're

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in now, where inflation is going along faster than in any other recession in our history. The free market is the only mechanism known to me to do the job, short of dictatorship, which I don't think any of us would look forward to. It is the only mechanism known to me that will bring about adjustments to the standard of living that are required by the quadrupling of the price of oil, for instance, and the lack of the abundance of crops that we are used to.

So we have a problem. But it exists in other countries, too, although Germany has done a better job than we have in controlling inflation--it's only about 7% this year as against 12% here. It's 12% in Canada; it's about 10% in Holland and Switzerland, which are usually exemplary in this regard. It's more than that in Britain and Italy. It's 25% in Japan. We have not done a very good job and what is even worse, some of the other important industrialized countries have done a poorer job than we have. I would say that, again, the solution to our economic dilemma of fighting inflation at the same time as recession is not only a most unusual one, it's one that defies a short term or a simple solution.

Many, however, are responding in part to a doom-and-gloom philosophy, which I think has permeated not only the stock market but the bond markets, and businessmen and consumers generally in the past few months. Let me mention a few favorable things. First of all, we are less than a million people below the all time record set just two months ago for employment in this country. We have something like 86,000,000 people employed today as against something

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like 80,000,000 as recently as 1960. Keep that in mind as we appraise the current developments in unemployment, which are certainly not satisfying to any of us as it has jumped from 5-1/2% to 6-1/2% within a period of three months.

We have floating exchange rates now, which make for better adjustments, particularly in a period like this, to the uneven effects of economic measures taken in the various countries of the world. If one country does not succeed in conquering inflation as well as another one, its exchange rate will be affected, leading to more expensive imports, and this will help to get them somewhat back on stream.

I ask you also to keep in mind, despite the difficulties of the problems that we face on economic policy, that the basic strength of this economy that we have still relies on--I know it is an old cliche--the free enterprise system. Even though it is regulated from here to a month of Sundays, it is not regulated as it is in many other countries. I think you can get general agreement even in Switzerland and Germany that in terms of the ultimate resolution of international economic problems, the U.S. dollar will play the most prominent role. We tend to associate, and I would mention journalists particularly in this regard, any "decline in the value of the dollar" with the word weakness; any change in the other direction as strength. These have somehow almost moral connotations of failure associated with weakness, of success associated with strength. It shouldn't be viewed this way. The ultimate

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strength or weakness is in terms of resource endowment and a viable economic system.

Mr. Friedman makes the point that all of the oil problems are only going to set back the increases in our standard of living in this country by something like six months. I think it's a little more difficult situation than that, but his point is well taken. We tend to put too much emphasis on that last million barrels of oil a day which we consume as being the be-all and end-all of economic policy requirements.

In the last analysis, I think we have the ingenuity as a nation and the strength as a nation to see ourselves through some challenges that are different--some that we really haven't seen before. But that's the history of our country. I'm not going to get up and wave the flag, but I think we've got the economic strength and the economic know-how to figure out solutions for these problems.

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