Update from the Federal Reserve Bank

Remarks of Mr. Robert P. Mayo,
President, Federal Reserve Bank of Chicago
to the Investment Seminar of the
National Association of Mutual Insurance Companies
Chicago, Illinois
October 23, 1975

I AM PLEASED TO HAVE THE OPPORTUNITY TO MEET WITH THIS GROUP AGAIN. IT HAS BEEN ONLY A YEAR SINCE I SAW YOU LAST BUT THE WORLD AND THE ECONOMY HAVE CERTAINLY CHANGED.

LAST YEAR, WE WERE SEEING THE END OF A VIGOROUS ECONOMIC EXPANSION. TOTAL OUTPUT OF GOODS AND SERVICES IN DOLLAR TERMS WAS STILL RISING BUT ADJUSTED FOR PRICES, THE DECLINE IN OUTPUT HAD ALREADY STARTED. WHILE THE HARBINGERS OF ECONOMIC DECLINE WERE EVIDENT, THE MAJOR FOCUS WAS ON INFLATION. THE WHITE HOUSE CONFERENCES ON INFLATION WERE HELD JUST A MONTH EARLIER AND THE SCRAMBLE BY PRODUCERS OF ALL TYPES TO CORRAL MATERIAL AND SUPPLIES TO HEDGE AGAINST INFLATION WAS STILL UNDERWAY.

NOW THE NATION IS EMERGING FROM WHAT TURNED OUT TO BE THE SHARPEST DECLINE IN REAL ECONOMIC ACTIVITY IN THE POST-WORLD WAR II PERIOD. WE HAVE, FOR THE SEVENTH TIME SINCE WORLD WAR II, WEATHERED ANOTHER ECONOMIC DOWNTURN.

BUT AS THE OLD ADAGE GOES, "THE MORE THINGS CHANGE, THE MORE THEY ARE THE SAME." THOSE OF YOU WHO WERE HERE LAST YEAR MAY REMEMBER

ME SAYING THAT I COULDN'T RECALL A PERIOD WHEN SO MUCH RADIO AND TELEVISION TIME AND PRESS COVERAGE HAD BEEN GIVEN TO MONETARY POLICY. IT'S THE SAME TODAY.

YOU MAY RECALL THAT I SAID THAT I WISHED THAT IN TALKING ABOUT INFLATION, WE WERE AS THE PHRASE GOES, "BEATING A DEAD HORSE." BUT I ADDED, "THE HORSE ISN'T DEAD; IT IS STILL VERY ACTIVE." IT'S STILL THE SAME TODAY.

YOU MAY RECALL THAT I ARGUED THAT WE CAN NOT AFFORD TO SET IN PLACE ECONOMIC POLICIES THAT WILL DEFEAT EFFORTS TO ACHIEVE LONG-TERM ECONOMIC GROWTH WITHIN THE BOUNDS OF REASONABLE PRICE STABILITY. IT'S THE SAME TODAY.

YOU MAY RECALL THAT I SAID THAT MONETARY POLICY FORMULATION CANNOT AND DOES NOT ESCAPE FROM THIS DIFFICULT AND PERPLEXING DECISION ENVIRONMENT. AND THIS, TOO, IS THE SAME TODAY.

BUT IN SPITE OF THE SAMENESS, AN UPDATE OF THE SYSTEM'S MONETARY POLICY ROLE IS STILL APPROPRIATE. THE CURRENT ECONOMIC ENVIRONMENT HAS INTENSIFIED THE INTEREST AND CONCERN IN THE SUBSTANTIVE PROBLEMS AND ISSUES CONFRONTING MONETARY POLICY.

THE FIGURES JUST RELEASED SHOW THAT A SIGNIFICANT RECOVERY IS UNDERWAY. THE SIZE OF THE UPTURN IN THE THIRD QUARTER IN TOTAL OUTPUT OF GOODS AND SERVICES IN "REAL" TERMS, IN INDUSTRIAL PRODUCTION, AND IN EMPLOYMENT IS NOT AT ALL ANEMIC. IT READILY MATCHES THE RECOVERY FOR EARLIER PERIODS.

WE SHOULD BE RELIEVED; WE SHOULD BE LOOKING AHEAD WITH CONFIDENCE. BUT MANY IN OUR SOCIETY ARE UNEASY AND UNCERTAIN.

THINGS ARE DIFFERENT THIS TIME. WE ARE COMING OUT OF THIS RECESSION WITH THE HIGHEST UNEMPLOYMENT, THE HIGHEST FEDERAL DEFICIT, THE HIGHEST INTEREST RATES AND THE HIGHEST RATE OF INFLATION OF ANY CORRECTION IN THE PEACETIME, POSTWAR PERIOD. NO WONDER THE CURRENT ECONOMIC SITUATION AND PROSPECTS ARE VIEWED WITH LESS THAN EUPHORIA! THE "SCENE", AS THE YOUNGER GENERATION WOULD CALL IT, IS LOADED WITH CHALLENGES.

THE BASIC CHALLENGE FOR ECONOMIC POLICY IS TO ACHIEVE A SUBSTANTIAL AND SUSTAINABLE EXPANSION IN REAL OUTPUT AND EMPLOYMENT WITHOUT FURTHER ESCALATION OF THE RATE OF PRICE INCREASES. AND WE MUST DO SO WITHIN THE CONTEXT OF OUR FREE ENTERPRISE ECONOMY AND WITHOUT LOSS OF PERSONAL FREEDOM.

LET'S BE CLEAR THAT THIS IS A SUBSTANTIAL CHALLENGE. INDIVIDUALS AND GROUPS WITHIN OUR SOCIETY HAVE DIFFERENT JUDGMENTS AS TO WHAT THE COSTS ARE, WHAT RISKS ARE EXCESSIVE, AND HOW THE COSTS SHOULD BE DISTRIBUTED OVER TIME AND AMONG THE VARIOUS SECTORS OF THE ECONOMY.

MY DIRECT INTEREST TODAY, OF COURSE, IS THE <u>CONTRIBUTION</u> THAT MONETARY POLICY CAN AND SHOULD MAKE IN MEETING THAT OBJECTIVE. I STRESS THE WORD CONTRIBUTION SINCE MONETARY POLICY CAN NOT BE OUR SOLE ECONOMIC POLICY TOOL. THIS POINT HAS BEEN FAR TOO FREQUENTLY IGNORED IN PUBLIC DEBATES WHERE EFFORTS ARE MADE TO FIND A SINGLE, SIMPLE SOLUTION TO OUR DIFFICULTIES. NOR CAN MONETARY POLICY BE USED TO OFFSET FULLY THE EXCESSES OF OUR OTHER ECONOMIC POLICY ACTIONS.

This is particularly important today with pressures increasing for expanded efforts to reduce unemployment more quickly--pressures to focus on unemployment now, ignoring or leaving inflation concerns until later. After all, some argue, we have extensive underutilization of human and industrial resources; we have time to switch our emphasis.

I think it is a tragedy that we have so often defined our economic problem as either inflation or unemployment. This choice doesn't exist--certainly not in the long run. I doubt that there is very much scope for this choice even in the short run. The experience since the mid-1960s clearly indicates that it is increasingly difficult to trade off more inflation against less unemployment; we can't switch from unemployment fighting to inflation fighting and then back again. In a very real sense it is the inflation that caused the unemployment.

A myopic policy strategy can only work if the public has what the economists call a money illusion--that is, they confuse changes in nominal income with changes in real income. If the public is confused or alternatively doesn't expect the rate of price increases to accelerate, then you can have an initial impact on unemployment by efforts designed to increase money income. The so-called "Phillips curve" seemed to work in the early 1960s when the variations in the inflation rate were low and the public was slow to perceive the changes in inflation rates. But the public has become attuned to inflation, so watch out! The period of time in which the trade off will work has become shorter and shorter.

I WOULD HASTEN TO ADD THAT THIS DOESN'T MEAN THAT WE CAN NOT OR SHOULD NOT USE FLEXIBLE ECONOMIC POLICY. BUT ALL OF OUR POLICIES—FISCAL OR MONETARY—MUST CONSIDER AND EMPHASIZE THE LONGER-TERM RESULTS OF OUR ACTIONS.

THIS EMPHASIS ON THE LONGER-TERM HORIZON IS VERY MUCH A PART OF FEDERAL RESERVE SYSTEM POLICY DECISIONS. WITH THE RELEASE LAST SPRING OF THE YEARLY GROWTH RATE TARGETS FOR THE MONETARY AND CREDIT AGGREGATES, THE PUBLIC NOW HAS SOME BASIS FOR JUDGING THE THRUST OF MONETARY POLICY. NOT THAT THESE TARGETS ARE ETCHED IN STONE; GOOD MONETARY POLICY REQUIRES THAT THEY BE REVIEWED PERIODICALLY AND CHANGED IF ECONOMIC CIRCUMSTANCES WARRANT. BUT THEY DO SERVE TO INDICATE OUR BEST JUDGMENT OF THE APPROPRIATE PATH FOR MONEY AND CREDIT EXPANSION, GIVEN NOT ONLY THE STAGE OF THE ECONOMIC CYCLE BUT THE OBJECTIVE OF REACHING ULTIMATELY STABLE LONG-TERM GROWTH. AND THEY ARE TAKEN VERY SERIOUSLY BY THE FEDERAL RESERVE SYSTEM.

FEDERAL RESERVE SYSTEM ATTEMPTS TO HEW TO LONGER-TERM PERFORMANCE OBJECTIVES OF THE MONETARY AND CREDIT AGGREGATES AND GREATER PUBLIC AWARENESS OF THIS HAS HAD SEVERAL IMPACTS. FIRST, THE ANNOUNCEMENT OF THE FED'S MONETARY AGGREGATES TARGETS AND THE HEIGHTENED AWARENESS ON THE PART OF THE INVESTING PUBLIC OF THE RELATIONSHIP BETWEEN RATES OF GROWTH IN THE AGGREGATES AND THE RATE OF INFLATION HAVE CONTRIBUTED TO THE INCREASED ROLE PLAYED BY EXPECTATIONS IN DETERMINING INTEREST RATE MOVEMENTS. FOR EXAMPLE, IN THE NOT TOO DISTANT PAST, THE CONSENSUS WAS THAT HIGHER RATES OF GROWTH IN THE AGGREGATES LED to lower interest rates. This is not necessarily the case now. If the aggregates have been expanding for some time at rates above the announced targets, the market comes to expect that the Federal Reserve will become less generous in supplying reserves over the near-term. This creates the expectation of rising short-term rates in the weeks ahead. If they act on these expectations, investors will begin to sell securities which will tend to raise actual short-term yields.

Second, efforts to hew to a longer-term target path have led, until recently, to higher interest rates. At this stage of the economic cycle, this development was viewed by many with distress. But we must keep aggregate money and credit growth under control if we are ultimately to restrain inflation.

We know that long-term rates are adversely affected by the rapid expansion of the aggregates because of inflationary expectations. This is why we see bearish bond markets when the money supply grows excessively and rallies when it grows at a more moderate pace. Those who have called for stepped up growth in the aggregates in order to lower long-term interest rates must either have not been following the market very closely in recent years or must be stuck with a large short position in bonds.

But keeping your eye on the long-term does not necessarily mean that interest rates must rise in an economy that has underutilized real resources. The problem arises from stacking public credit demands on top of private demands. As long as the aggregates are under control, the stacking isn't bothersome but once the stack gets too large, either interest rates must rise to allocate available credit or the monetary and credit aggregates must rise. And it is the latter which we must guard against. Full accommodation by the Fed might hold interest rates down temporarily and insure nonfederal borrower access, but would lead quickly to higher rates of inflation and higher interest rates in turn.

Earlier in the recovery, crowding out fears were even more rampant than today. In my view, there was some overreaction by the market to these fears, forcing interest rates higher than was justified by the underlying demand and supply conditions. Certainly, private credit demands have not as yet taken off and we were seeing more reaction to anticipated problems than actual problems as recent interest rate developments suggest.

I do not and cannot take a sanguine view of the Treasury deficit, however. The current Treasury estimate of $44 to $47 billion of new cash in the second half of 1975 must be viewed with concern. A continuation of deficits on the current scale cannot be countenanced by anyone truly concerned with the viability of the private sector of this economy.

For my part, I see no basis for the Fed to accommodate all borrowing demands--both federal and private--by trying to keep interest rates artificially low. To do so would mean giving up efforts to

REACH ULTIMATELY FULL EMPLOYMENT WITH STABLE PRICES--EVEN WHEN WE DEFINE BOTH OF THESE TERMS RATHER FLEXIBLY. BUT NOT ACCOMMODATING ALL OF THE GROWING NON-FEDERAL NEEDS IN THE FACE OF CONTINUING BUDGET DEFICITS OF THIS MAGNITUDE MEANS FEDERAL GOVERNMENT CONTROL OVER A LARGER AND LARGER PORTION OF OUR TOTAL SPENDING. THIS DISTURBS ME GREATLY BUT I AM CONVINCED THAT MONETARY POLICY CANNOT AND SHOULD NOT BE REQUIRED TO MAKE THE DECISION ON THE ALLOCATION OF SPENDING BETWEEN THE PRIVATE AND THE PUBLIC SECTORS. FORTUNATELY, WE HAVE RECENTLY ESTABLISHED PROCEDURES TO IMPROVE THE FEDERAL GOVERNMENT'S APPROACH TO PLANNING NATIONAL PRIORITIES. HOPEFULLY, THE FULL IMPLEMENTATION OF THE CONGRESSIONAL BUDGET AND IMPOUNDMENT CONTROL ACT OF 1974 WILL SERVE TO LIFT THIS UNWANTED AND INAPPROPRIATE BURDEN FROM THE SHOULDERS OF MONETARY POLICY.

BUT THAT WILL TAKE TIME. FOR THE NEAR TERM, THE FINANCIAL OUTLOOK DEPENDS CRITICALLY ON WHETHER OR NOT THE FEDERAL DEFICIT CAN BE HELD AT OR NEAR THE ADMINISTRATION'S TARGET. AND, OF COURSE, THE RECORD ON THE GROWTH OF PRIVATE CREDIT DEMANDS IS STILL TO BE WRITTEN. I MUST CONCEDE THAT IF THE RECOVERY IS STRONG, THEN THE ATTENDANT PRIVATE CREDIT DEMANDS CANNOT HELP BUT PUT SOME PRESSURE ON INTEREST RATES. MY HOPE IS THAT RENEWED VIGOR IN THE ECONOMY AND TIGHT BUDGETARY CONTROL WILL ALLOW THE MARKETS TO HANDLE THE EMERGING CREDIT DEMANDS IN A REASONABLE MANNER DURING THE PERIOD AHEAD.

IN THE FINAL ANALYSIS, OF COURSE, THE SUCCESS OF A FORWARD-LOOKING POLICY DEPENDS CRITICALLY ON WHETHER THE MONETARY AND CREDIT

AGGREGATE GOALS CHOSEN ARE APPROPRIATE. FOR NOW, TOO HIGH GOALS LEAD TO FURTHER INFLATION; TOO LOW GOALS MEAN AN OVERLY SLUGGISH OR EVEN ABORTED RECOVERY. OBVIOUSLY, I FEEL STRONGLY THAT THE MODERATE PATH CHOSEN FOR MONETARY POLICY IS APPROPRIATE.

THE RECOVERY SO FAR IS TESTIMONY TO THE APPROPRIATENESS OF OUR MONETARY AND FISCAL POLICY ACTIONS. IN THE AREA OF FISCAL POLICY, PUBLIC EMPLOYMENT PROGRAMS WERE EXPANDED, UNEMPLOYMENT INSURANCE WAS LIBERALIZED, AND INCOME TAXES WERE REDUCED. IN ADDITION, CHANGES IN THE INVESTMENT TAX CREDIT ALLOWANCE HAVE STRENGTHENED INCENTIVES FOR BUSINESS INVESTMENT IN FIXED CAPITAL.

ON THE MONETARY SIDE, INTEREST RATES--PARTICULARLY SHORT TERM RATES--HAVE FALLEN DRAMATICALLY FROM THEIR 1974 HIGHS AS A RESULT OF DECLINING CREDIT DEMANDS AND A MORE ACCOMMODATIVE MONETARY POLICY. IN THE PAST SIX MONTHS, M_1 (PRIVATE DEMAND DEPOSITS PLUS CURRENCY AND COIN HELD BY THE NONBANK PUBLIC) HAS INCREASED ABOUT 5 PER CENT ON A SEASONALLY ADJUSTED BASIS AND M_2 (M_1 PLUS CONSUMER TYPE TIME DEPOSITS AT COMMERCIAL BANKS) ABOUT 9 PER CENT.

AS A RESULT OF THESE PROGRAMS, CONSUMER SPENDING HAS PICKED UP, INVENTORY LIQUIDATION IS LARGELY COMPLETED, PRODUCTION HAS BOOSTED, AND THERE HAS BEEN A REDUCTION IN THE INFLATION RATE.

CORPORATIONS HAVE TAKEN ADVANTAGE OF THE EASIER CREDIT CONDITIONS BY IMPROVING THEIR LIQUIDITY POSITIONS THROUGH THE FUNDING OF A GREAT PORTION OF THEIR SHORT-TERM DEBT. BANKS AND OTHER FINANCIAL INSTITUTIONS HAVE ALSO USED THE PERIOD OF SLACK CREDIT DEMAND TO REPAIR THEIR LIQUIDITY POSITIONS. CONSUMERS, TOO, PUT THEIR FINANCIAL

HOUSES IN ORDER BY PAYING DOWN INDEBTEDNESS AND MAKING ADDITIONS TO THEIR LIQUID FINANCIAL ASSETS. ALL OF THESE FACTORS ACTED TO INCREASE ECONOMIC ACTIVITY IN THE THIRD QUARTER AND TO FORM A SOLID FOUNDATION UPON WHICH FURTHER RECOVERY CAN BUILD.

I AM WELL AWARE THAT WE ARE NOT YET, SO TO SPEAK, "OUT OF THE WOODS". THE CAPITAL GOODS INDUSTRY, AS IS TYPICAL IN A RECOVERY, IS STILL LAGGING; CONSTRUCTION AND HOUSING, IN PARTICULAR, ARE NOT LEADING THE RECOVERY AND COULD AGAIN BE CAUGHT IN DISINTERMEDIATION PROBLEMS, AND THERE ARE THE UNEASY, UNCERTAIN OVERHANGS OF NEW YORK CITY'S DIFFICULTIES AND ENERGY AND FOOD PRICE PRESSURES.

BUT IN THIS COMPLEX OF PROBLEMS AND DIFFICULTIES, I SEE ABSOLUTELY NO BASIS FOR ARGUING THAT THE MAINTENANCE OF A MODERATE MONETARY POLICY STANCE CHARACTERIZED BY A 5 TO 7 1/2 PER CENT RATE OF M_1 GROWTH FROM THE SECOND QUARTER 1975 TO THE SECOND QUARTER OF 1976 WILL NOT SERVE AS AN APPROPRIATE COMPLEMENT TO ECONOMIC RECOVERY. IT IS A COURSE THAT I BELIEVE WILL PROMOTE SUSTAINABLE ECONOMIC GROWTH AND AT THE SAME TIME WILL CONTINUE TO BANK THE FIRES OF INFLATION. I REALIZE THAT THIS POLICY PRESCRIPTION MAY NOT REDUCE THE UNEMPLOYMENT RATE AS FAST AS WE ALL WOULD PREFER. BUT A PERMANENT REDUCTION IN THE RATE WILL REQUIRE FURTHER SACRIFICE. WITH UNEMPLOYMENT INSURANCE, FOOD STAMPS, MEDICAID, AND OTHER TYPES OF INCOME MAINTENANCE PROGRAMS, THE MISERY SUFFERED BY THE UNEMPLOYED HAS BEEN LESSENED AND THE BURDEN IS ALSO BEING SHARED BY THE EMPLOYED, SINCE IT IS THIS LATTER GROUP THAT MUST FUND THESE PROGRAMS.

We are also beginning to realize that inflation is very costly. Policies leading to inflationary pressures result in the long run in the destruction of jobs, not in their creation. The very groups which are to be helped are hurt the most. The operation of our tremendously productive economy becomes distorted and in the final analysis the very fabric of society is affected.

The counsel of patience is never very popular. But it is appropriate in this setting. With a willingness to accept a longer horizon, the country can again enter an era of steady economic growth. I am convinced that we will do so.