REMARKS OF MR. ROBERT P. MAYO
PRESIDENT, FEDERAL RESERVE BANK OF CHICAGO
TO THE ECONOMIC STUDENT ASSOCIATION
UNIVERSITY OF WISCONSIN
MARCH 6, 1979

I AM PLEASED TO HAVE BEEN INVITED TO MEET WITH THE UNIVERSITY OF WISCONSIN ECONOMIC STUDENT ASSOCIATION. IT IS ALWAYS EXCITING TO BE WITH STUDENTS, PARTICULARLY ECONOMICS STUDENTS. YOU HAVE MORE THAN THE USUAL PUBLIC INTEREST IN ECONOMIC POLICY AND ARE LIKELY TO BE FULL OF QUESTIONS --TOUGH BUT IMPORTANT QUESTIONS.

I FEEL VERY MUCH AT HOME WITH ECONOMISTS. I WORKED AS AN ECONOMIST AT THE WASHINGTON STATE TAX COMMISSION IN THE LATE 30'S AND IN THE U.S. TREASURY FOR 20 YEARS AS WELL. AND NOW, OF COURSE, I AM AN ECONOMIC PRACTITIONER--AN ECONOMIC POLICYMAKER.

GIVEN MY BACKGROUND AND MY CURRENT POSITION, I AM MINDFUL OF GEORGE STIGLER'S DICTUM. "ECONOMISTS POSSESS THEIR FULL SHARE OF COMMON ABILITY TO INVENT AND COMMIT ERRORS. PERHAPS THEIR MOST COMMON ERROR IS TO BELIEVE OTHER ECONOMISTS."

NOW, OF COURSE, I DON'T WANT YOU TO DISBELIEVE ME. SO I AM GOING TO STAY AWAY FROM A RIGOROUS THEORETICAL MODEL BUILDING EXERCISE WHICH WOULD BE CERTAIN TO CONTAIN ERRORS. AFTER ALL, EVEN THE TOP THEORISTS RARELY CAN GET AGREEMENT FROM A MAJORITY OF THEIR COLLEAGUES. INSTEAD, I WANT TO TAKE A POLICYMAKER'S POSTURE AND TALK AS MR. GRAN SUGGESTED ABOUT THE ECONOMY'S PROBLEMS AND THE ROLE FOR MONETARY POLICY IN THE CURRENT SITUATION. AND I WOULD LIKE TO DO THIS PRIMARILY FROM MY PERSPECTIVE AS A POLICYMAKER.

I HAVE BEEN AT THE FEDERAL RESERVE BANK OF CHICAGO FOR THE PAST 8 1/2 YEARS. I HAVE PARTICIPATED IN MORE THAN 100 MEETINGS OF THE FEDERAL OPEN MARKET COMMITTEE--WHICH, AS YOU KNOW, IS THE PRIMARY MONETARY POLICYMAKING

GROUP IN THE FEDERAL RESERVE SYSTEM. THAT IS A LARGE ENOUGH SAMPLE, I THINK, TO BE ABLE TO DRAW SOME RELIABLE CONCLUSIONS. THE MEETINGS ARE NOT INDEPENDENT EVENTS, BUT AT TIMES EVEN I WONDER IF THE SAMPLE IS BEING DRAWN FROM THE SAME UNIVERSE.

IN THE TIME I HAVE SPENT IN THE MONETARY POLICYMAKING ARENA, I HAVE SEEN: THE DEMISE OF THE FREE RESERVES CONCEPT; THE RISE AND DEMISE OF RPD'S (RESERVES AGAINST PRIVATE DEPOSITS); THE RISE OF EMPHASIS ON THE MONETARY AGGREGATES; THE INTRODUCTION OF EXPLICIT TARGET PATHS FOR M-1, M-2 AND M-3; THE INCREASING CONCERN ABOUT THE RELIABILITY OF OUR MONETARY AGGREGATE MEASURES AND WHAT NOW MAY BE A COMPLETION OF THE CIRCLE, SUGGESTIONS THAT A BANK RESERVE MEASURE MAY BE THE BEST GUIDE FOR MONETARY ACTIONS.

THESE TWISTS AND TURNS IN EMPHASIS HAVE FREQUENTLY BEEN INTERPRETED BY THOSE OUTSIDE THE SYSTEM--ACADEMICS AND FED WATCHERS ALIKE--AS EXAMPLES OF ELEGANT SOLUTIONS BEING FRUSTRATED BY STUPID POLICYMAKERS.

THAT IS HARDLY THE CASE. EACH CHANGE IN EMPHASIS HAS BEEN LED AND ACCOMPANIED BY VOLUMINOUS INPUT FROM ECONOMISTS. BUT ECONOMISTS DON'T ALWAYS AGREE. IN FACT, IN THE POLICY ARENA ONE MIGHT SAY THAT THEY SELDOM AGREE. FURTHER, THE EFFECTIVENESS OF ELEGANT SOLUTIONS ARE INFLUENCED BY FEASIBILITY AND ACCEPTABILITY. IS IT, FOR EXAMPLE, FEASIBLE TO ARGUE FOR A RAPID DECELERATION IN THE RATE OF GROWTH IN THE MONETARY AGGREGATES IGNORING THE IMPLICATIONS FOR SHARP, SHORT-RUN OUTPUT AND EMPLOYMENT DECLINES? I THINK NOT, ESPECIALLY WHEN WE KNOW THAT CONGRESSIONAL STIMULATIVE ACTION WILL INEVITABLY FOLLOW. POLICYMAKERS MUST CONDITION THEIR RESPONSES TO THE REALITIES OF THE WORLD AROUND US--TO THE KNOWN IMPEDIMENTS TO ADJUSTMENT OF OUR ECONOMY--TO THE LIKELY REACTIONS OF OTHERS.

BUT I AM GETTING AHEAD OF MY PLANNED APPROACH TODAY. I DON'T INTEND TO MAKE A FORMAL REVIEW OF THE ISSUES RELATING TO THE MONEY STOCK VERSUS

INTEREST RATES AS POLICY TARGETS, THE CHOICE AMONG MONETARY AGGREGATES, THE COST OF MISSING MONETARY TARGETS OR THE USE OF RESERVES, THE MONETARY BASE OR FED FUNDS AS OPERATING TARGETS. MOST OF YOU KNOW THE ARGUMENT. INDEED, EACH OF YOU MAY HAVE A POSITION. RATHER, I WANT TO PROVIDE A LITTLE OF THE SETTING IN WHICH RECENT MONETARY POLICY DECISIONS HAVE BEEN MADE AND SOME PERSPECTIVE FOR THE PERIOD AHEAD.

WE WILL VERY SOON--NEXT MONTH--BE ENTERING OUR FIFTH YEAR OF ECONOMIC GROWTH SINCE THE RECESSION OF 1974. THIS EXPANSION OUTRANKS IN LONGEVITY EVERY PRIOR CYCLICAL UPSWING OF THE POST-WAR ERA WITH THE EXCEPTION OF THAT IN THE 1960S. IT WILL BE DIFFICULT TO SUSTAIN A CONTINUED PACE OF EXPANSION. SLOWER GROWTH IN HOUSING, PERSONAL CONSUMPTION EXPENDITURES AND BUSINESS CAPITAL SPENDING--AND EVEN GOVERNMENT SPENDING--ALL APPEAR TO BE LIKELY AND WOULD BE EXPECTED TO LEAD TO A SUBSTANTIAL MODERATION OF THE PACE OF ECONOMIC EXPANSION AS THE YEAR PROGRESSES. NEVERTHELESS, MY OWN VIEW IS THAT WE WILL SEE POSITIVE, BUT NONETHELESS, SLOW GROWTH THIS YEAR. RECENT EVENTS IN IRAN COULD TIP US INTO THE NEGATIVE COLUMN BUT I AM ENCOURAGED BY RECENT EFFORTS TO RESTORE IRANIAN OIL PRODUCTION EVEN THOUGH AT LESS THAN PRIOR PRODUCTION LEVELS (AND AT INCREASED PRICES).

WE ENDED 1978 ON A VIGOROUS NOTE. EMPLOYMENT, OUTPUT, NEW ORDERS, INCOME AND RETAIL SALES WERE ALL RISING SOLIDLY. SOME OBSERVERS ARE CONCERNED THAT THE MORE THAN SIX AND A HALF PERCENT RATE OF REAL ECONOMIC GROWTH IN THE FOURTH QUARTER MAY BE SIGNALING THE START OF A BOOM-AND-BUST BUBBLE. I DOUBT THAT THIS IS THE CASE. I EXPECT TO SEE THE FIGURES COMING THROUGH IN A LESS VIGOROUS FASHION AS THE YEAR PROGRESSES.

HOUSING HAS STARTED TO FEEL THE IMPACT OF RESTRICTIVE MONETARY POLICY. BUT IT IS THE ONLY SECTOR SO FAR SHOWING SIGNS OF WEAKNESS--AND EVEN THERE WITH NO SIGNS OF A DECLINE ANYWHERE NEAR AS STEEP AS IN 1974. CONSUMER

SPENDING, A MAJOR SOURCE OF STRENGTH THROUGHOUT THIS EXPANSION, IS LIKELY TO TAPER OFF A LITTLE BIT. THE RISING BURDEN OF CONSUMER DEBT HAS BEEN FREQUENTLY CITED AS A LIKELY REASON FOR MODERATION IN CONSUMER OUTLAYS. WHILE CERTAINLY A FACTOR, I DON'T SEE THIS AS LEADING TO ANY SHARP CUT-BACK IN PERSONAL SPENDING.

BUSINESS INVENTORIES HAVE BEEN MODERATE, EVEN LOW, IN RELATION TO SALES. AS A RESULT OF CAUTIOUS INVENTORY POLICIES, THE REDUCTION OF INVENTORIES ACCOMPANYING LOWER OVERALL GROWTH IS NOT LIKELY TO BE AS SERIOUS AS IT WAS FIVE YEARS AGO.

INDICATORS OF THE PROBABLE PACE OF CAPITAL INVESTMENT ARE MIXED. CURRENTLY, ORDER BACKLOGS FOR NONRESIDENTIAL CONSTRUCTION AND EQUIPMENT INDICATE A FURTHER RISE IN CAPITAL SPENDING. BUT BUSINESS INVESTMENT INTENTIONS SURVEYS INDICATE A SLOWER GROWTH IN SPENDING. HIGHER INTEREST RATES AND EXPECTATIONS OF SLOWDOWN IN ECONOMIC ACTIVITY ARE LIKELY TO RESULT IN SOME HOLDING BACK OF INVESTMENT PLANS.

PURCHASES OF GOODS AND SERVICES BY BOTH FEDERAL, STATE AND LOCAL GOVERNMENTS WILL BE RISING THIS YEAR BUT THE RISE SHOULD BE VERY MODEST IN REAL TERMS. FURTHER, THEY ARE NOT LIKELY TO OFFSET REDUCTIONS IN HOUSING AND BUSINESS FIXED INVESTMENT.

OUR ECONOMY REMAINS REMARKABLY WELL BALANCED. THERE ARE STILL NO SIGNIFICANT EXCESSES AFTER ALMOST FIVE YEARS OF EXPANSION. THAT'S AN AMAZING RECORD. IT ALSO STRIKES A VERY POSITIVE NOTE, SINCE ECONOMIC BALANCE REDUCES THE CHANCES FOR SHARP DECLINES IN ACTIVITY. BUT NEITHER DOES THE ECONOMY HAVE MUCH ROOM FOR RAPID EXPANSION. WE ARE OPERATING AT OR CLOSE TO CAPACITY IN SUCH VITAL SECTORS AS TRANSPORTATION FACILITIES, STEEL, CEMENT, OIL REFINING, AND VARIOUS TYPES OF EQUIPMENT MANUFACTURING. WE HAVE A LARGER PERCENTAGE OF OUR WORKING AGE POPULATION EMPLOYED TODAY THAN AT ANY PREVIOUS

TIME IN OUR HISTORY. ADDITIONAL ECONOMIC STIMULUS WOULD ONLY EXACERBATE INFLATION.

EVEN WITH SLOWER GROWTH IN THE ECONOMY THIS YEAR, I MUST CONFESS I DO NOT EXPECT TO SEE ANY SWEEPING STRIDES IN WINDING DOWN INFLATION. THE LIKELY SUCCESS OF THE PRESIDENT'S WAGE AND PRICE STANDARDS PROGRAM IS STILL A QUESTION MARK. LABOR CONTRACT BARGAINING IS SURE TO BE VIGOROUS THIS YEAR. WITH CONTINUED RAPID ESCALATION OF FOOD PRICES, THE NEWLY EFFECTIVE INCREASES IN MINIMUM WAGE AND SOCIAL SECURITY TAXES, THE UNFORTUNATE RISE IN OPEC OIL PRICES, AND THE CONTINUED PASS-THROUGH OF HIGHER PRICES FOR IMPORTS, THE CHANCES OF ANY SIGNIFICANT MODERATION IN PRICE RISES IS SMALL.

CLEARLY, THE CENTRAL ISSUE IS TO AVOID STRONG AGGREGATE DEMAND PRESSURES THAT WOULD AGGRAVATE OUR ALREADY SERIOUS INFLATION PROBLEM. BUT AT THE SAME TIME WE MUST HOLD IN PLACE SUFFICIENT FISCAL AND MONETARY POLICY RESTRAINT TO RELIEVE INFLATIONARY PRESSURES OVER THE LONG PULL WITHOUT TRIGGERING A RECESSION.

UNDOUBTEDLY, ONLY MODEST IMPROVEMENT IN REDUCING THE RATE OF INFLATION ALONG WITH SLOWER ECONOMIC GROWTH CAN WEAKEN THE RESOLVE OF CONGRESS TO FIGHT INFLATION. AND IF MODEST IMPROVEMENT IS ACCOMPANIED BY SIGNIFICANT DECLINES IN OUTPUT AND EMPLOYMENT THE RESOLVE OF CONGRESS WOULD PROBABLY BE DESTROYED.

AS CHAIRMAN MILLER HAS INDICATED IN HIS RECENT REPORT TO CONGRESS, THE FEDERAL RESERVE SYSTEM BELIEVES THAT WE CAN WALK THAT NARROW LINE. IF FISCAL POLICY MAINTAINS THE STANCE OUTLINED IN THE PRESIDENT'S BUDGET MESSAGE, THERE IS A PATH WHICH MONETARY POLICY CAN TAKE THAT HAS A REASONABLE CHANCE OF ACHIEVING OUR GOAL OF MODERATING PRICE PRESSURES WITHOUT TRIGGERING A RECESSION.

To that end, the Federal Open Market Committee has selected growth ranges for the monetary aggregates that it believes will bring an appropriate degree of restraint in light of the current outlook for fiscal policy and the underlying strength of private demand in the economy. Over the year ending with the fourth quarter of 1979, M-1 is expected to grow between 1 1/2 and 4 1/2 percent and M-2, 5 to 8 percent.

That growth rate for M-1 implies a marked deceleration from the pace of recent years--7.9 percent in 1977 and 7.3 percent in 1978. But lest you get worried about too rapid a deceleration, let me remind you that part of the lowering of the range reflects an expectation that the shifting of funds to savings accounts with automatic bank transfer facilities and the recently authorized NOW accounts in New York State will continue to depress the growth of demand deposits throughout 1979. That shift could dampen M-1 growth this year by as much as 3 percentage points. However, we have only had a brief experience on which to base this projection and, therefore, there is a broad range of uncertainty.

All of you are aware, I assume, that M-1 has been flat in recent months. In fact, the level of M-1 for published February data is below that for September.

Frankly, we have had difficulty in explaining this flatness even in the light of the ATS and NOW account developments. As a result, the M-1 performance has added an obvious uncertainty to FOMC deliberations. It is impossible to tell whether the weakness of M-1 relative to what would have been expected on the basis of historical relationships among money, income and interest rates is a transitory phenomenon or one that is likely to persist for some time. If the recent weakness does reflect a change in the public's allocation of funds among various financial assets that will persist

FOR SOME PERIOD OF TIME, THEN THE CORRECT POLICY RESPONSE WOULD BE NOT TO REACT BY REDUCING RESTRAINT ON THE ECONOMY. IF, HOWEVER, IT IS TEMPORARY, ONLY ONE OF THESE FREQUENT FLUCTUATIONS IN THE NUMBERS, THEN THE CORRECT RESPONSE WOULD BE TO EASE RESTRAINT.

THUS, INTERPRETATION OF THE NUMBERS IS CRITICAL FOR POLICY. BUT YET M-1 SEEMS TO BE A SOMEWHAT AMBIGUOUS INDICATOR OF POLICY. THUS, IT BECOMES ESPECIALLY IMPORTANT TO MONITOR CAREFULLY THE BEHAVIOR OF OTHER FINANCIAL VARIABLES.

THE FEDERAL RESERVE IS TRYING TO CORRECT THE PROBLEM OF MEASUREMENT OF THE AGGREGATES. PROPOSALS FOR REDEFINITION OF THE MONETARY AGGREGATES ARE UNDER STUDY. AMONG THE PROPOSALS MADE IN A STAFF PAPER PUBLISHED FOR PUBLIC COMMENT IN THE JANUARY FEDERAL RESERVE BULLETIN IS THAT M-1 BE RE-DEFINED TO ENCOMPASS ATS, NOW AND OTHER SIMILAR TRANSACTION ACCOUNTS. SUCH A REDEFINITION WON'T ELIMINATE THE NEED TO UNDERSTAND THE BEHAVIOR OF VARIOUS FINANCIAL ASSETS. BUT IT MIGHT PRODUCE AN AGGREGATE MORE REFLECTIVE OF THE PUBLIC'S NEED FOR TRANSACTION BALANCES IN LIGHT OF ONGOING INSTITUTIONAL CHANGES.

M-1 IS NOT THE ONLY PUZZLING AGGREGATE. THERE ARE QUESTIONS AS WELL REGARDING THE MOVEMENTS OF THE INTEREST-BEARING COMPONENTS OF THE BROADER AGGREGATES--ESPECIALLY THE TIME AND SAVINGS DEPOSITS AT COMMERCIAL BANKS IN M-2. BANK SAVINGS DEPOSITS HAVE DECLINED APPRECIABLY IN THE PAST FEW MONTHS, DESPITE AN INFLOW TO ATS ACCOUNTS. SAVINGS DEPOSITS MIGHT BE EX-PECTED TO BE WEAK WHEN MARKET RATES ARE HIGH, BUT A LARGE GAP HAS EXISTED FOR SOME TIME SO YOU WOULD HAVE EXPECTED MOST OF THE INTEREST SENSITIVE FUNDS TO HAVE ALREADY SHIFTED. PERHAPS WITH RECENT HIGH NOMINAL INTEREST RATES, PEOPLE HAVE BEEN MORE AGGRESSIVE IN SEEKING OUT MARKET YIELDS.

THESE DIFFICULTIES SHOULD NOT BE TAKEN TO IMPLY THAT MONETARY POLICY HAS NO BASIS FOR MAKING A DECISION OR THAT THE MONETARY AGGREGATES SHOULD BE DISCARDED. THE LATTER WOULD BE EQUIVALENT TO THE OLD LINE ABOUT THROWING THE BABY OUT WITH THE BATH WATER. IT DOES, HOWEVER, SUGGEST THE NECESSITY OF SOMETHING OTHER THAN A PURELY MECHANISTIC RESPONSE FUNCTION TO MONETARY AGGREGATE DEVELOPMENTS. OTHER FINANCIAL VARIABLES MUST ALSO BE SEARCHED FOR CLUES AND SO MUST DEVELOPMENTS IN THE REAL ECONOMY.

ALL OF US ON THE COMMITTEE KNOW THAT MONETARY POLICY ACTIONS AFFECT THE ECONOMY WITH A LAG. WHAT IS HAPPENING TODAY IS NOT THE RESULT OF TODAY'S ACTIONS--OR LAST WEEK'S, OR LAST MONTH'S. IF WE WAIT UNTIL WE SEE THE UNDESIRED EVENTS OCCURRING IN THE ECONOMY, IT WILL BE TOO LATE. BUT EVEN SO, TRENDS IN THE REAL ECONOMY, WHETHER IN ORDERS, INVENTORIES, CAPITAL EXPENDITURES OR OTHER SIGNS OF PLANS FOR THE FUTURE GIVE US SOME FEELING ON THE POSITION WE ARE IN. AND SO DO RELATED FINANCIAL AND CREDIT MARKET DEVELOPMENTS.

THE POLICY DECISION TO BE MADE CURRENTLY IS NOT AN ISSUE OF MONETARIST VERSUS NON-MONETARIST APPROACHES TO MONETARY POLICY. BOTH HAVE A GREAT DEAL OF UNCERTAINTY AT THE MOMENT. BOTH ARE KEENLY AWARE THAT ONE OF THE MAJOR MONETARY POLICY FAULTS IN THE PAST HAS BEEN TO HOLD TO A POSITION OF RESTRAINT TOO LONG. BUT BOTH ARE ALSO CONCERNED AS WELL ABOUT THE INFLATIONARY PRESSURES IN THE SOCIETY AND BOTH RECOGNIZE THE CRITICAL ROLE OF MONETARY POLICY.

IN HIS INVITATION TO ME, MR. GRAN SAID "AS YOU KNOW, OUR ECONOMY IS IN A PRECARIOUS SITUATION." IT IS IN TERMS OF UNCERTAINTY, BUT NOT IN TERMS OF ITS DEPENDENCE ON CIRCUMSTANCES BEYOND OUR CONTROL. IN SPITE OF THE CURRENT DIFFICULTIES, THERE IS A POSSIBILITY THAT THIS YEAR WILL USHER IN A NEW ATTITUDE ABOUT ECONOMIC POLICY--A NEW POSTURE BASED ON LONGER TERM SOLUTIONS TO OUR ECONOMIC PROBLEMS RATHER THAN "QUICK FIXES" THAT CAN'T AND DON'T WORK.

THERE IS A SURPRISING PERVASIVENESS OF AN ATTITUDE OF ACCEPTANCE OF A REDUCED PACE OF ECONOMIC ACTIVITY. WE MAY NOT BE SO QUICK TO REVERSE FEDERAL POLICY GEARS. MAYBE WE WILL BE MORE WILLING AS A NATION TO ACCEPT A SOMEWHAT SLOWER SPEED FOR THE ENGINE. CERTAINLY WE HAVE SEEN THIS IN THE ECONOMIC REPORT OF THE PRESIDENT. WE HAVE SEEN IT TOO IN THE FACT OF LESS --OR NONEXISTENT--PRESSURE TO REVERSE MONETARY POLICY PREMATURELY.

I AM HOPEFUL THAT WE WILL BE ABLE TO MODERATE MONETARY POLICY RESTRAINT AT THE APPROPRIATE TIME THIS TIME AROUND THE CYCLE. AND I AM HOPEFUL WE WILL BE ABLE TO MAINTAIN A REASONABLE FISCAL AND MONETARY POLICY POSTURE IN ORDER TO MAKE SUBSTANTIAL PROGRESS TOWARD A MORE STABLE LESS INFLATIONARY ECONOMY.