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BANK CREDIT AND ECONOMIC GROWTH

Thank you very much, Bob. I must say that I was somewhat surprised by the invitation to appear at another meeting of the Ohio Association of Economists and Political Scientists. Those of you who attended the panel discussion in which I participated last year may recall that my principal function (whether intentional or not) seemed to be to inflame the other participants and the audience. Thus, I was surprised--and, indeed, highly honored--to be asked again to address this distinguished and erudite group. You have a capacity for forbearance and tolerance that speaks well for the colleges and universities of Ohio.

I would like to review with you some of the problems that confront those of us who are directly responsible for the formulation of monetary policy against a background of nearly 10 years of grappling with those problems--not always too successfully, I must admit. To paraphrase the Bureau of the Census, the best way to understand tomorrow's problems is to know where we are today. To do that, we must know something about the major policy developments of the recent past.

The problems that confront the monetary authorities today, I believe, have their roots in the early 1960's and were compounded later on by inappropriate imbalances that developed over the decade. To bring us all up to a common starting point, I shall divide the 1960's into two subperiods: 1960-65, and 1966-70; and shall examine a few significant developments in each time period.

1960-65

During the latter part of the fifties and early sixties, price stability was given an extremely high priority in the formulation of stabilization policies. As a result, the economy experienced cyclical instability and under-utilization of resources. In 1960 and early 1961, the economy underwent a mild business recession, with relatively high unemployment, a low rate of utilization of plant capacity, and a low rate of growth in real Gross National Product. (In 1961, unemployment was 6.1 percent, only 79 percent of plant capacity was being utilized and the increase in real GNP over the preceding year was only 2 percent.) The slack that then existed--along with reasonable price stability--provided a solid base for the balanced economic expansion that occurred in the early sixties. The new architects of policy during that period (and here I specifically refer to those in the Administration at that time who drafted the broad outlines of national economic policy, rather than the Federal Reserve System and its staff) had a single objective, which can be best expressed in one word: growth. In that period, the concept of moving the economy onto a long-run, full-employment growth path was the subject matter of many articles in learned journals, convention speeches, and professional meetings. This goal was warmly embraced by the Administration's Council of Economic Advisers.

The specific prescriptions for growth were an expansive monetary policy, and a fiscal policy that included higher levels of Federal spending, lower Federal taxes, and larger Federal deficits. These policies were gradually successful. Prices remained virtually stable until late in the

period. Plant utilization increased to 89 percent, and the unemployment rate declined to about 4.5 percent by 1965. Also, the real Gross National Product increased at an average annual rate of 5 percent in the period from 1960 to 1965.

The Federal Reserve System adapted itself to the national policy of economic growth. Bank credit was allowed to rise at an average annual rate slightly in excess of 8 percent in the early 1960's and the money supply increased at an annual rate of about 3 percent. Housing starts rose rapidly, and Federal expenditures for defense expanded. In addition, large expenditures on our space program, and notable successes in that area, moved us, so to speak, halfway to the moon.

And then something went wrong with our economy. The reasons are not entirely clear, even today. Just as we seemed to be on the verge of success, we made a major shift in our military commitment in Vietnam. The additional economic thrust from increased defense expenditures at a time when the economy had already reached the full-employment range proved to be excessively stimulative. As a result, we were not given a chance to see if we could continue to grow at a high employment level of activity and maintain relatively stable prices. Instead, the excessive demand thrust us into a situation of overemployment, and prices began to rise rapidly.

Thus, it appears that the immediate "trigger" of the sharp increase in prices in 1965 was the escalation of the war in Vietnam. The subsequent inflation and the change in economic and social priorities led to a shift in resources away from many urgent domestic programs. This was a major reason for the extreme distaste for the conflict that has persisted ever since.

The failure to maintain noninflationary growth represents, I think, an area of concern for economists and political scientists, and one that deserves extensive research in the university community. I recommend it to you and to your students. The question that we need to investigate is: can we have high and rising levels of employment and earnings and high rates of utilization of plant capacity, all without price inflation? Perhaps the answer is "yes"--provided we are able to solve the social, political, and economic problems that seem to be generated when a highly-skilled, highly-organized industrial economy approaches the upper limits of its productive capacity and its supply of skilled labor. What seems to happen during such a period is that all of the participants in the productive process--Government, labor, and industry--seek to achieve rates of growth in their real incomes that cannot be satisfied when the growth rate of the aggregate product begins to subside. This is purely conjecture on my part: further research in this area should receive a high priority.

By the end of 1965, one fact at least was clear: forces had been set in motion that would, in the absence of an appropriate mix of monetary and fiscal policies, result in price inflation. The Federal Reserve System, thus, began to move, first gradually and then more rapidly, towards a policy of monetary restraint.

1966-70

The latter part of the decade of the 1960's was a period of over-employment and inflationary pressures. These economic imbalances were accompanied by sudden and sharp shifts in public economic policies--particularly monetary policy. The opportunity to achieve orderly non-inflationary growth at high levels of employment was past. Over the period, a series of policy level decisions were made and executed that, in retrospect, appear to have been almost as destabilizing as the inflationary problems these policies were designed to correct.

Thus, in late 1965, the Federal Reserve System, in an effort to restrain inflation moved to tighten monetary policy, which turned out to be a single-handed move because it was not assisted by appropriate fiscal restraints. Monetary policy eventually became highly restrictive, culminating in the severe credit crunch of the third quarter of 1966. Late in 1966, demand pressures temporarily abated, and signs of an involuntary inventory accumulation appeared. Monetary policy was then relaxed, and the Federal Reserve System pumped a substantial volume of reserves into the banking system through most of 1967 in an attempt to prevent the inventory adjustment that had been induced by tight money from degenerating into a recession.

The System again reversed policy late in 1967, following the devaluation of the pound sterling, when it became apparent that, in the absence of a restrictive move on the fiscal front, the economy would soon again be faced with an intensification of inflationary pressures.

Many in the Administration had repeatedly urged changes in fiscal policy throughout most of the post-1965 period. These policy recommendations, however, were not acted upon, and virtually the entire burden of stabilization policy fell on the Federal Reserve System. At long last, after many months of haggling and delay, Congress finally moved on the fiscal front. In July 1968, legislation was passed imposing a 10 percent surcharge on personal and corporate income taxes and limiting specific Federal expenditures.

At this juncture, most forecasters (both those using judgmental techniques and those using econometric models) predicted that the temporary surtax would induce a serious contraction in economic activity, unless there was an offsetting move on the part of monetary policy. Apparently, most forecasters did not make allowance for the temporary nature of the tax and the limited effects of such a change on consumer and business spending plans. The System, at that point, made what many now consider to be a major blunder by moving quickly to soften the impact of the tax increase by easing up on bank credit and the money supply. In a few months, however, it became apparent that actual developments were not consistent with general economic predictions. Consumer and wholesale prices rose rapidly; labor demanded higher and higher wages; and businessmen began purchasing plant and equipment at an unsustainable rate in an effort to offset rising labor and construction costs.

The System then (December, 1968) moved to a policy of restraint, and rates of growth in the money supply and the flow of bank credit were

reduced. The economy had already begun to slow down and monetary policy further strengthened the restrictive forces at work; consumer takings began to level off and the rate of increase of production began to subside. While no overt change in monetary policy was made during 1969, policy was executed in such a way as to become progressively more restrictive. This policy of increasing restraint continued throughout 1969 even though by year end there were outright declines in bank credit, and the money supply. As a result, real Gross National Product actually declined in the fourth quarter of the year.

One of the difficulties with the policy of increasing restraint, as I attempted to explain when I met with you in Columbus last year, is that prices--particularly consumer prices--and wages--especially those of organized labor--are not immediately responsive to changes in economic conditions and, hence, are sticky economic indicators. The rates of increase in prices and wages usually slow down to sufficiently tolerable levels only after many months of slack in the economy. In the meanwhile, this slack is reflected in higher unemployment rates and lower rates of utilization of plant capacity. Moreover, the risk of bringing about a deep recession at a time when prices and wages are still rising is a very serious one under a policy of mounting restraint. A preferred approach might have been to follow a less severely restrictive policy, that is, to exercise a degree of restraint that would have permitted the monetary and credit aggregates to grow, but at rates below those required in a high

employment economy. In that manner, excess demand would gradually have been eliminated, inflationary pressures would gradually have subsided, and the stage would have been set for an eventual resumption of economic growth at high-employment levels without price inflation. All of this could have been done--so argued a few of us--without a high risk of a costly recession, which in our political system might have triggered an extravagant splurge in government spending, shrinking Federal revenue, and a return to an inflationary monetary policy.

Monetary Policy in a Changing World

I wish that I could say that I know exactly what the appropriate policy should be for the period immediately ahead. The economy is beset on all sides by grave domestic and international problems, and it is difficult to predict such developments with any degree of certainty. For example, few were prescient enough to predict such things as the illegal mail strike, the air controllers' "sick-out", or the flair-up of military activities in Cambodia and Laos, all developments of the last few weeks.

A month or so ago, I was confident that the Federal Reserve System was on the right track. Short-term interest rates were easing, banks were able to secure a modest volume of loanable funds through the sales of CD's in certain maturity ranges, and--judging by conditions in financial markets--the worst of the deep credit freeze of 1969 seemed to be a matter of history. Furthermore, it now appears that the March statistics for money supply and bank credit will show large increases

in both aggregates, although because of previous monthly movements in these monetary indicators, the overall results for the first quarter of 1970 will be only modest growth. I still think that these developments, given what we know at the moment, represent moves in the right direction.

Nevertheless, I am becoming increasingly concerned about the shape of fiscal policy with every day that passes. The mail strike, for example, has resulted in a 6 percent increase in wages for Government employees, retroactive to December 27, plus another 8 percent recommended for postal workers. Thus, the fiscal picture has changed drastically. Already, the Federal budget had lost most of its restraining influence on the economy, as the budget in late fiscal 1970 moved from surplus to deficit. The wage changes now being discussed would add about $3 billion to Federal payrolls in fiscal 1971, and, thus, would be inflationary, unless offset by higher postal rates, higher taxes, or lower spending in other areas. It would be most unfortunate if fiscal policy became highly stimulative just at the time when the first signs of ease in financial markets are beginning to appear.

The appropriate course for monetary policy in view of these developments is still highly problematical. The Federal Reserve System must base its actions on what it knows to be the case, rather than on what might develop under altered circumstances. Consequently, the System must walk a narrow path between the two extremes of a serious

recession and a rapid acceleration of inflationary pressures. Given a fair amount of good luck, a middle-of-the-road policy of moderate restraint involving limited growth in bank credit and the money supply, should eventually return the economy to a noninflationary path. But the situation may change rapidly and if so, the System must be prepared to change rapidly to meet the new conditions. In view of the record of fiscal policy in the 1960's, an independent, flexible monetary authority still seems to be our best hope for meeting the emerging economic situation.