

"MONETARY POLICY AND THE ECONOMIC OUTLOOK"  
Financial Executives Institute  
Denver, Colorado  
March 8, 1979

As president of the Federal Reserve Bank of Kansas City, one of my major functions is to engage in the formulation of monetary policy. Along with the presidents of the other eleven Reserve Banks and the seven members of the Board of Governors, I serve on the Federal Open Market Committee which makes monetary policy decisions.

In order to make policy it is necessary to have a good grasp of the current state of economic affairs. At this time, the U. S. has completed nearly 4 years of economic expansion. During that time, real output has grown at the very satisfactory rate of 5 per cent per year. Furthermore, this has been a balanced expansion with no major dislocations yet occurring. Of special importance is the fact that businessmen have kept their patterns of inventory accumulation under good control.

During this expansion period we have achieved some of the strongest employment growth in our postwar history. From the bottom of the recession in early 1975 to the beginning of 1979, more than 13 million persons have been added to the nation's employment rolls. As a result, the ratio of employment to population in the U. S. has risen to a record-high 59 per cent.

While the expansion to date has been generally satisfactory, we are also experiencing a severe economic problem: the very high

rate of inflation. The consumer price index rose by 9 per cent in 1978—making last year the worst year for inflation in America since 1974. And price data for January are disappointing, to say the least—the producers price index rose at an annual rate of over 15 per cent and consumer prices rose at nearly a 10 per cent rate.

In this situation, the primary questions facing economic policymakers like myself is how best to cope with our serious inflation problem. One approach to the problem is to see what we can learn from the past. In recent inflationary periods, we have tried several things. For example, in the early 1970's we tried to cure inflation by the use of direct control of wages and prices. But that experience showed us once again that direct controls are not a long-run cure for inflation. And we were reminded once again of the negative and counter-productive side-effects that controls have on the efficient allocation of resources in our economy.

We have also seen, in the recent past, the use of recession as a means to slow down the rate of price increase. Experience and analysis show that recession—and even a period of slow economic growth—result in a slowdown in the rate of growth of wages and prices. But experience and analysis also tell us that there are significant costs to the recession and slow growth cures for inflation. Included in these costs are both increases in unemployment and the giving up forever of output that would have been produced without a recession.

These significant costs of recession have, in our recent past, led to quick turnarounds in economic policy as those costs have been perceived. The result of quick changes from restraint to stimulation to restraint has been a "stop-and-go," or roller coaster, effect. This policy roller coaster has produced unsatisfactory results for both unemployment and inflation.

With these experiences to learn from, economic policy is now trying a new approach. Because of the costs of recession and the likelihood of pressures leading to another trip on the roller coaster, both fiscal policy and monetary policy are now publicly committed to a policy of keeping the economy on a slow growth path. The purpose of this slow growth policy is to reduce the rate of inflation over an extended period of time, without a recession.

How are we going about this approach? In the area of monetary policy, with which I am concerned, the F.O.M.C. has chosen growth rate objectives for the monetary aggregates in 1979 that we believe will provide sufficient restraint to reduce inflationary pressures without bringing on a recession. From the end of 1978 to the end of 1979, M-1 (demand deposits and currency) is expected to grow between 1 1/2 and 4 1/2 per cent; and M-2 (M-1 plus bank time and savings deposits other than large CD's) is expected to grow between 5 and 8 per cent. The degree of monetary restraint applied over the past year and the money

supply growth objectives for 1979—along with the fiscal policies now in place and announced for the period ahead—are expected to produce slow real output growth in 1979. Real GNP is expected to grow at about a 2 per cent rate this year (compared to about 4 per cent growth last year), and the overall unemployment rate is expected to rise only moderately by year end.

An important feature of the slow growth cure for inflation is that we will not, unfortunately, see quick results. Indeed, Chairman Miller estimates that it will take from 5 to 7 years to wring out the inflation that has become embedded in our economy.

Not only will the slow growth cure for inflation require an extended period of time. It is also not a "sure thing," in the sense that there are several possible problems associated with the approach at this time.

First, recent changes in the nation's financial structure—such as the introduction of Automatic Transfer Savings accounts—are making it more difficult than usual to understand and to use the monetary aggregates as tools of monetary policy.

Second, it may turn out that slow growth without recession may not be attainable. "Fine tuning" of the economy is a very difficult thing to do, and we might slide into a recession without desiring it. Fine tuning for slow growth may be compared to riding a bicycle. When riding a bicycle, if you don't keep moving you are going to fall down. And maybe you will fall down if you just try to go too slowly.

Third, we can't afford to be unlucky—in the sense that unforeseen shocks to the economy can upset the slow growth "game plan." For example, the recession of 1974-75 and the aggravated inflation that accompanied it were both worsened by a set of unforeseen shocks: the oil embargo, the related energy shortages and price increases, and the worldwide food shortage. Already in 1979 we have had the impact of the situation in Iran and its related effects on world oil prices. It is still too early to know if these factors will be enough to throw our economic policy off course, but they can only make our problems greater.

Aside from these problems, what are some of the requirements for success in fighting inflation in the present economic environment? Perhaps most important is a determined commitment, on the part of both monetary policy and fiscal policy, to continue the anti-inflation battle. Too often we have gone the roller-coaster route, as the determination to bring inflation under control has given way to the very real pressures on policymakers to go from restraint to stimulus of economic activity. Happily, at this juncture, both fiscal policy and monetary policy are publicly committed to "staying the course" until inflation is substantially slowed.

At the same time, there are a number of sources of help in the fight against inflation that, if brought into the battle, could lighten the task facing monetary and fiscal policy. Let me briefly mention several examples.

1. Social security tax increases, such as those going into effect at the beginning of 1979, are directly inflationary because they are a part of the labor costs paid by business. The recent increases might be rescinded, if possible. If not, future increases might be eliminated or scaled down.

2. Minimum wage rate increases both directly and indirectly raise the overall wage costs of business, and thus add to price increases. Further increases in the minimum wage might be postponed; and a lower minimum might be set for youth.

3. Trade restrictions, such as the steel target price system, raise prices to U. S. consumers and business both through higher import prices and higher prices for domestic substitutes.

4. Depending upon the form that they take, agricultural price supports may increase food costs and the overall inflation rate, through reduction of supplies or through contributions to an increase in the Federal deficit.

5. Some government legislation, such as the Davis-Bacon Act, escalates costs and prices in particular industries—here, construction.

6. Certain environmental and safety requirements of the Federal government increase costs and prices. The inflationary consequences of such regulations should be weighed against their social benefits in reaching decisions. And the timetable for their implementation might be extended.

7. Productivity improvement through promoting investment in modern plant and equipment would reduce labor cost increases and thus reduce the rate of inflation. One channel for promoting investment in new plant and equipment is the use of tax incentives such as the recent reductions in the corporate income tax and the greater use of the investment tax credit. Certain regulatory restraints on investment might also be examined, in order to determine how to minimize their negative impact on investment.

8: Finally, the Administration's wage-price program can make a contribution to slowing the inflation by providing "a standard for constructive behavior on the parts of both business and labor." Of course, any success the program has will depend on its being a complement to monetary and fiscal policy restraint on aggregate demand.

Indeed, the contribution of all the supplementary anti-inflation items just discussed depends on the maintenance of an appropriate economic environment on the part of monetary and fiscal policy. It is also true, however, that help on the anti-inflation front from some or all of these factors would make the task of monetary policy easier, and would increase the likelihood of reducing the inflation rate without a recession. But in any case, monetary policymakers—and the American people as well—must be willing to face this time of testing with a firm resolve to bring our inflation under control.