

THE SAME OLD PROBLEM--A NEW PERSPECTIVE

Remarks by

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Before the

Bank Management Association

St. Louis, Missouri

April 17, 1980

When Bo Naunheim invited me to speak to the Bank Management Association here in St. Louis, he also was kind enough to provide a suggested title for my remarks. This title--"The Same Old Problem--A New Perspective"--had the same appeal to both of us: No matter what startling developments occurred in the economy or in financial markets in the ensuing weeks, the title would still be appropriate, because the same old problem of inflation wasn't going to disappear quietly one afternoon in April. Now, if Bo had just been thoughtful enough to supply the text of my remarks, including a list of workable solutions for our economic troubles, then my visit with you would have been even more enjoyable.

In the five or six weeks since Bo asked me to talk with you tonight, the price you charge your best customers has continued to move upwards at a rather formidable pace. Likewise, the prices you pay for much of your raw material money have continued at historically high levels.

We all know that these record interest rates are due largely to the nation's inflation. As bankers, you need no lengthy recitation of inflation statistics: whether you choose to follow the Consumer Price Index's climb from 9 per cent in 1978, to nearly 13 per cent in 1979, to the current 18 per cent annual rate--or if you prefer the slightly less painful numbers of the GNP deflator--the facts are agonizingly clear. Inflation has extracted a severe

price from our nation. And the inflation cures which are called for will likely bring additional distress during the period of adjustment which lies ahead.

Why do we have this inflation? What can we do about it?

In my judgement, the inflationary environment of the 1970's-- and its unwanted legacy in the 1980's--has a number of roots. The "guns and butter" policy pursued during the Vietnam War is surely a cause, and so is the sharp increase in energy prices since the mid-1970's. Another contributor is the deterioration in the economy's productivity in the 1970's--which probably flows from changes in the labor force, a slower pace of capital investment, and excessive governmental regulation. Monopoly elements in labor and product markets also contribute to inflationary pressures by reducing the responsiveness of certain prices and wages to market forces.

Most importantly, it seems to me, the inflationary fires have also been stoked considerably by the deficit spending of the Federal Government accompanied by rapid growth in the supply of money and credit. As you all know, deficit spending and rapid money growth lead to demand in the economy that is not met by the economy's capacity to supply goods and services--and that initiates inflation.

Add to all these factors something we call inflationary expectations. Once businessmen and workers begin to expect inflation to continue, they base price and wage decisions on

the belief that increases are needed to offset the inflation they will experience, and the inflation process becomes firmly anchored in the economy.

To summarize my view, I believe the most important causes of inflation have been deficit spending by the Federal Government accompanied by rapid monetary growth, although the other factors--particularly rapidly rising energy costs in the 1970's--have certainly played a role.

This short review of inflation and its causes takes care of part of the ideas suggested in the title of my remarks. But there is another aspect of the "same old problem." As bankers and concerned citizens, you are aware that most discussions of inflation also incorporate some more or less standard proposals of policies needed to combat inflation. Undoubtedly you are familiar with a generally accepted anti-inflation program, which is, indeed, a good one. It usually includes:

- a balanced Federal budget
- moderate growth in money and credit to support moderate, sustainable, economic expansion
- energy policies that encourage both production and conservation of energy to reduce our dependence on OPEC
- tax policies or other actions that will stimulate investment and bring about improvements in productivity

Most of you would agree, I think, that immediate implementation of those policies would contribute to a diminished rate of inflation and the building of a base for sustainable, longer-term economic growth. Unfortunately, those sound anti-inflation

solutions still rest in the "same old problem" category because they are mostly still unfinished business. Up to now, you and I have seen little evidence that our nation is willing to move effectively to curb inflation. A notable exception, of course, is more restrictive monetary policy and the more recent Federal Reserve actions designed to restrain credit growth.

As a nation, we do know what policies are required, but we generally have been unwilling to take the medicine that might permanently slow inflation. We don't like the thought that a straightforward attack on inflation and its causes may result in less buoyant economic growth and a slower rise in our standard of living.

Does our hesitancy to meet inflation head on mean that we are destined always to suffer periods of devastating inflation countered by episodes of equally damaging recession and unemployment? Is such an unwelcome cycle inevitable?

I don't think so. In fact, I detect that the wind has changed, bringing us better economic policy tools and more determination for a fresh assault on inflation. As a result, moreover, I believe there is indeed a new perspective to go along with that same old problem. This new perspective is characterized by what I see as a real opportunity for us in 1980 to improve or enhance our public economic policies--and to do so with the growing support of the general public.

Let's examine more closely this opportunity of 1980--the one we must grasp decisively. It seems to me that this opportunity has three key elements which must be fully exploited.

These elements are (1) improved monetary policy, (2) a more determined anti-inflationary fiscal policy, and (3) the awareness and even anger of a public stunned by inflation.

As for improvements in the anti-inflationary capabilities of monetary policy, you all know that the Federal Reserve's "Saturday night special" of October 6 heralded a renewed attack on inflationary excesses, bringing increases in the discount rate and in certain reserve requirements. On that same date, we announced a change in our monetary policy procedures. These new procedures place more emphasis on bank reserves in controlling money, and less emphasis on interest rates. A result of this new emphasis on reserves is that interest rates will be allowed to vary along with the demand for money and credit. It's clear that this new procedure has contributed to the sharp increase in short-term interest rates in recent months. But it's also clear that our new procedure has contributed to the Federal Reserve's success in moderating money growth since October. In my judgement the Federal Reserve has begun to effectively exploit this opportunity for improved monetary control.

Another way through which the Federal Reserve will help blunt inflationary forces in 1980 lies in our intention to administer the special credit restraint program with a firm hand. As you well know, the restraint package incorporates a 6 to 9 per cent range in bank loan growth in 1980 and includes other forms of restraint on bank lending. The program does not intend to discourage a reasonable flow of credit to small businesses, agriculture, and the homebuilding industry. Although the credit

restraint program is intended as a temporary action, it undoubtedly will reinforce the more restrictive Federal Reserve policies initiated in October and other subsequent steps.

Additional potential for the Federal Reserve to improve its firm anti-inflationary stance will begin to come on stream this year as a result of the President's signing of the Depository Institutions Deregulation and Monetary Control Act of 1980. We in the Federal Reserve particularly applaud the responsible support of financial institutions which led Congress to create this package. Not only will this legislation provide more equitable treatment of financial institutions and enhance competition among them, but it should lead to the further improvement in the Federal Reserve's ability to conduct monetary policy. Since under this new law reserve requirements will be uniformly applied to all depository institutions of like size, monetary policy will have a direct impact on a wider range of financial institutions. The broader impact will increase the effectiveness of monetary policy at crucial times such as these, while spreading the burden of reserve requirements more equitably through the nation's financial system.

From my perspective as a Federal Reserve policymaker, let me assure you that we welcome the potential of these improvements in our policy capabilities. I will urge their application firmly, but wisely, to bolster the fight to wring inflation from our economy. If our resolve remains strong, I have no doubt that these policies will make a material contribution in the battle against inflation.

But we all know that monetary policy alone cannot halt inflation. Other public policy tools must be brought into the fray. This brings me to the second major opportunity I see to combat inflation in 1980, the use of the Federal Government's fiscal policies. The publicly stated intentions of the Administration and Congress to balance the 1981 budget should be applauded and encouraged by all of us who are concerned about the inflationary pressures which have resulted from the deficit Federal spending in 19 of the last 20 years. Further, many of us would urge Federal spending cuts in the current fiscal year, as well as the establishment of a positive commitment for future Federal budgetary discipline. Such an approach coupled with the consistent, credible monetary policy to be put forth by the Federal Reserve, would clearly signal progress in retarding inflation growth.

None of us are so naive to believe that stringent monetary policies and restrictive fiscal policies can expect to succeed against inflation unless there is a broad base of public support for such policies. Therein lies the third major opportunity for anti-inflation progress in 1980--drawing on the impetus of public awareness of the severe impacts and penalties of inflation. Scary headlines about the prime rate and the CPI may make us wince in pain, but after the wince comes the stark eye-opening reality of inflation.

Because inflation exempts no American household, because inflation is draining our economy of its vitality, and most

importantly, because inflation is causing us to be less optimistic about the future, I believe Americans will now respond to policies which are credible and which demonstrate a clear commitment to restore order to our economic structure. Aren't the noisy public demonstrations in recent weeks against high interest rates really demonstrations against inflation? I think so.

If my assessment about the significant opportunities of 1980 are correct, then now is the time we should resolve to marshal monetary and fiscal policies and public opinion to bring about a new noninflationary economic environment.

We are all well-aware of the economic and social costs which must be paid to extract us from the inflationary spiral. The cost is slower growth--even recession, with higher unemployment, lost production, and other unfortunate side effects. But the earlier we move effectively against inflation, the sooner the period of adjustment will occur and pass, and the sooner we can look forward to the stability which will bring renewed prosperity and growth to our economy.

But what if we don't grasp these opportunities of 1980? What if we again fail to act decisively against inflation? We have no choice. In my judgement, failure to take firm, coordinated action now can only lead to a further speed-up in inflation. In short, dealing with 15 or 18 per cent inflation now is far less painful than the cure required for 25 or 30 per cent inflation the next time around.

If you agree with me that the opportunities are here--that the time is indeed right to move firmly against inflation, continue your support of the Federal Reserve policies and programs designed to fight inflation. Continue your support of responsible fiscal policy. In particular--given the mood of the nation in this election year, when the banner of fiscal conservatism could well become a rallying point--support candidates whose records and statements stand for economic reason.

What else can be done? Work more intensively to assure that your customers and associates understand the ultimate goals of public economic policies. Help them to comprehend that future business cycles may well look different--that slower economic growth may well be a permanent fact of business life in coming years. Above all, continue to be leaders as well as lenders. With your help, we will succeed.

In conclusion, let me assure you that the Federal Reserve needs and appreciates your support. We need support now as the anti-inflation fight heats up. We may well need it later during the inevitable business downturn which accompanies our search for long-run economic stability, especially if our appropriate but unpopular policies come under fire. If we can hold firm, we can look forward with you to a time perhaps when rapid inflation and serious economic instability will be only unpleasant memories.