

FUTURE ROLE OF THE FEDERAL RESERVE
IN THE FIGHT AGAINST INFLATION

Remarks by
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The last time I was invited to speak to this group in February two years ago, a heavy snow storm hit the area and, much to my regret, I was unable to make it to Oklahoma City as scheduled. This time, thanks to the scheduling foresight of ~~Mr.~~ ^{John} ~~Booth~~, the pleasant weather today is much more accommodative as well as typical of Oklahoma weather during the fall; all of which makes it a particular pleasure to be with you here ~~today~~ ^{tonight}.

I should hasten to add, however, that while the weather ~~situation~~ ^{Somewhat more} is pleasant, the economic situation, both current and prospective, is much less comforting. To a ~~group~~ ^{Gathering} such as this, I am ~~certainly~~ ^{sure that I} don't need to elaborate on the many serious economic problems that currently afflict our nation. The list of these problems is discouragingly long: slow economic growth, ~~higher~~ ^{than desired} unemployment, energy shortages, lackluster productivity gains, high and volatile interest rates, and, of course, a chronic inflationary situation. The most serious ^{of these} in my judgment, and perhaps the principal ^{cause} ~~causal factor~~ of most of the other problems is the cancerous-like ^{Wage & Price} ~~inflationary problem~~ that is now virtually strangling the very economic vitality of this ^{Nation} ~~country~~. It is appropriate, therefore, that I take this opportunity to discuss with you here ~~today~~ ^{tonight} the role of the Federal Reserve in ~~the~~ ^{on going} fight against inflation.

In approaching this topic, I believe it would be ~~helpful~~ ^{useful} if I first briefly reviewed what the Federal Reserve has done over the past year in the fight against inflation. In

doing so, I want to respond to certain critics of Federal Reserve policy who claim ^{that our past policy actions} ~~we~~ have allowed the money supply ^{as well as} ~~and~~ interest rates to fluctuate much too widely. And then, secondly, I want to comment on the economic outlook, with particular emphasis on the future role and ^{the} economic implications ^{on appropriate} of Federal Reserve monetary policy.

Looking back at the past year, none of us can be very pleased with the performance of the economy nor with the record that ^{has been} ~~was~~ posted on inflation. Indeed, it was out of concern that inflation would accelerate in 1980 that the Federal Reserve announced in October of 1979 the adoption of new operating procedures designed to improve our control over the growth rate of the money supply. Underlying this change in procedures was the recognition that ^{gradual} a reduction in the growth rate of money is a necessary ingredient to eventually reducing inflation. To be sure, the Federal Reserve has for some time established targeted growth rates for money believed appropriate for the ^{and consistent with the objective of reducing inflation.} economy ~~but~~ our record has not been very good in actually achieving those annual money supply targets. Thus, it was felt, to better control the growth of money over the long run, new operating procedures were necessary that would place less emphasis on pegging interest rates in financial markets and more emphasis on ^{the supply of} reserves ^{available} in the banking system.

These new procedures, and the coincident shift to a monetary policy of firm restraint, have been severely tested

during the past year. Indeed, the economic circumstances in which the Federal Reserve has operated during the year have been extraordinary. At the outset of 1980, as you ^{may} recall, there was a marked acceleration of inflationary pressures and expectations brought about by higher oil prices, the Middle East crisis, ^{and} growing concern about ^{large} deficits in the Federal budget. These inflationary pressures, ^{Continuing} ~~in turn,~~ ^{operating against a firm Monetary Policy} were instrumental in driving up interest rates to historically high levels last spring. And, as a result of these high interest rates, business activity posted a record decline during the second quarter.

As a fallout of the economic downturn in the second quarter, the demand for money and credit declined rapidly ^{with the result that} and interest rates also fell sharply. Under our new operating procedures, ^{was} ~~we at the Fed~~ ^{were} much more tolerant of this decline in interest rates because we wanted to keep money growth within our targeted ranges. Because of this policy, the sharp decline in interest rates served to break the economic downturn and set the stage for a business recovery ^{→ Commencing} in the ~~third~~ quarter. Also, because of this policy, the unemployment rate ^{did} ~~has~~ not rise ~~to~~ the very high levels that were earlier forecast.

In recent months, the business recovery has been somewhat stronger than generally expected. And, reflecting this business upturn ^{in an environment of} ~~despite~~ continuing high rates of inflation, the demand for money and credit has risen sharply once again. The Federal Reserve has responded to this recent ^{surge in money growth} ~~situation~~ in a

manner perfectly consistent with our ^{Previously} announced policies. In order to keep the growth of money within our targeted ranges, we have not ~~tried~~ ^{Provided the additional reserves necessary} to keep interest rates at artificially low levels. Rather, we have allowed interest rates to move freely in financial markets, in the belief that—in these inflationary times—it is more important ^{in the long run} to prevent an excessive growth rate of money.

In assessing our record with respect to monetary control, it is of course true that the money supply has moved in an erratic fashion on a week-to-week ~~and~~ ^{and even on a} month-to-month basis. You should be aware, however, that if we ~~would have~~ ^{were to attempt to} prevented these swings, it would ~~have been~~ ^{be} necessary for interest rates to have move in an even more volatile manner than ^{has} actually occurred. Thus, there is ^{direct} a trade-off between the control of money in the ~~short~~ ^{short run} and the volatility of market interest rates.

I would further point out that it is not the month-to-month or even the quarter-to-quarter movements in the money supply that ~~matter~~ ^{is important}, but rather the longer run trends. In this regard, I should emphasize that, despite the difficult circumstances in which we have operated this year, the monetary aggregates currently stand in reasonable alignment with the ranges ~~set~~ set for the year—although on average they are a bit higher than we would like.

In retrospect, therefore, I believe the Federal Reserve has played a significant role in the fight against inflation this year. We have, in a very determined sense, followed a policy of monetary restraint. And, that policy has helped to contain ^{inflation and more importantly,} inflationary

expectations in the face of some troubling developments that would otherwise have led to substantially higher inflation. By so doing, however, we have also played a role in the recent increase in interest rates. While a rise in interest rates cannot be considered a favorable development at this stage of a business recovery, I firmly believe that a shift to an easier ~~monetary~~^{money} policy in order to bring interest rates back down would not be wise. If we did so, quite likely the result would be an increase in inflationary expectations, higher interest rates later on, and a worsening in future economic activity.

All of which brings me to the question of the future role of the Federal Reserve in the fight against inflation. On this matter, I want to be brief and to the point. In the period ahead, in my judgment, there is no doubt that the Federal Reserve will continue to follow a policy of firm monetary restraint. Such a policy, which has already been announced in general terms, will be directed at achieving a slower growth rate of money in 1981 than in 1980.

Having said that, I want to hastily add that none of us should be deluded into thinking that a significant reduction in price inflation is likely to be achieved soon or that the task will be easy ~~and~~^{or without costs.} painless. In a very real sense, significant problems ~~may~~^{likely} will develop in the economy as the momentum of a decade of inflationary expectations collides with a policy of firm monetary restraint.

To prevent such a collision from having a sharply negative

impact on the level of business activity in 1981, it is absolutely essential that the ~~Fed~~ ^{Federal Reserve} not be cast in the role of ~~fighting the battle~~ ^{fighting the battle} ~~being to do it all~~ ^{alone}. In short, the role of the Federal Government's fiscal policy ~~is~~ ^{becomes} extremely important at this point in time. ^{if we are to be successful.}

What many people are now hoping for, including many financial market participants, is that fiscal policy will begin to play an active and meaningful role in the fight against inflation. And, for that role to be ^{most} effective, in my judgment, the new Administration must indicate at the outset that it will be taking firm, clearcut, and credible steps to restore balance to the Federal budget.

As you know, a balanced budget can be achieved in a number of ways. One approach, which has been the practice in recent years, is to follow up large spending increases by raising taxes and allowing inflation to push up government revenue. Clearly, that type of ~~fiscal~~ ^{Spending and taxing} policy does not fight inflation. ^{A more logical} ~~another~~ approach, and one that is needed in the period ahead, is one that will hold down and even reduce government spending. And, to the extent that defense spending is increased and some taxes reduced, it is even more important that a lid be clamped on nondefense spending. Only in this way will the budget be balanced in a noninflationary way.

In brief, what is vitally needed in the fight against inflation is not just a continuation of a restrictive Federal Reserve monetary policy. What is also needed is a coordinated and restrictive spending policy on the part of the Federal Government.

A third ingredient for a successful anti-inflationary program, besides the application of restrictive monetary and fiscal policies, is the acceptance by the general public of these policies. The public must be willing to support economic policies that promise long-run benefits but entail—in the short run—a period of economic slack and high unemployment.

The extent to which the public will support such a program ^{will} ~~may~~ depend upon the length and magnitude of the period of economic slack. Unfortunately, ^{no body} ~~we don't~~ know how long or how severe the period of slack will need to be. Some people fear that a lengthy period of adjustment is required; while others believe a short period will be sufficient. Those taking the optimistic short-term view stress the importance of affecting the public's inflationary expectations. If the public becomes convinced that the Government's policies will be effective in reducing ^{future} inflation, ~~it's argued~~, actual prices in the marketplace will not be bid up as rapidly.

I believe there is some merit in this latter view, and, therefore, I believe economic policymakers now have a unique opportunity to affect the rate of inflation. As you know, a new Administration and a newly constructed Congress have a ~~considerable~~ number of options open to them. If the new Administration were to seize this opportunity and clearly enunciate a policy of fiscal restraint involving a firm lid on government spending and move to a balanced budget, I believe it would go a long way in breaking the rising momentum of inflationary expectations and pressures that are building up for 1981.

In conclusion, we should all have no doubt that the application of persistent and credible policies of monetary and fiscal restraint is absolutely essential to an effective anti-inflationary program. We should also be fully aware that the application of such policies will inevitably result in a temporary dampening of business activity. However, I firmly believe that the long-run benefits of such policies to curb inflation will far and away exceed the short-run economic costs. Only through a reduction in price inflation, in my judgment, is there any real hope for attaining both lower and more stable interest rates, an environment conducive to increased capital investment, ~~and~~ to a growth in productivity, and to higher and sustainable levels of employment and national income.

For that reason, therefore, I want to assure you that whatever the course of fiscal policy in the period ahead, the Federal Reserve System will continue to ^{exercise its authority in a responsible way} ~~do its part~~ in the all-important battle against inflation.

*and become a
fiscal partner* It is my hope that fiscal policy will join with monetary policy, and together ~~and~~ with the support of the general public - we will be successful in the period ahead.