

Statement by

E. Gerald Corrigan

President, Federal Reserve Bank of Minneapolis

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Thank you for inviting me to appear before you today. I welcome this opportunity to share with you my thinking on the current problems and prospects for our economy, and I look forward to the opportunity to learn of your views on these complex issues.

Obviously, the United States economy is going through a difficult but necessary period of adjustment and transition. The symptoms of these difficulties abound here in the Dakotas and throughout the country at large. In that setting, there is a natural and understandable tendency to focus on what's wrong -- to take a one dimensional view of the problems of the day. That tendency can be misleading, for even from the vantage point of the last 18 months, it is possible to point to some positive developments. For example, as recently as the first quarter of 1980 we were all looking at a very bleak picture; financial and commodity markets were in disarray; oil prices were surging dramatically higher; political events, particularly in the Mid-East, had taken on an alarming tone; the grain embargo was in place; the dollar was being buffeted in the world markets and, most ominously of all, the headlines in our newspapers told of an alarming rise in the inflation rate, with some measures showing the inflation rate at a 15 to 18 percent annual rate of increase. Indeed, to some observers, it seemed as if the economy was on the verge of a classical inflationary blow-out.

Now, some fifteen short months later, I think we can say that things have not turned out anywhere near as badly as some

of the doomsday scenarios that were on people's minds in early 1980. To be sure, we did experience a short-lived and sharp decline in economic activity in the second quarter of last year, but in the ensuing months the aggregate economy has been surprisingly strong. Market conditions, while still not wholly satisfactory, have improved, the dollar is strong abroad, and -- most importantly -- we now have some signs -- however tentative -- that the inflation rate may be receding a bit. And, if we are all a bit tentative in concluding that inflation is turning down, certainly we can say with some confidence that the prospect of an inflationary blow-out has been arrested.

Yet, I would be far less than candid if I left you with the impression that I think we are out of the woods. We are not. Economic performance still leaves much to be desired. Inflation remains high, unemployment is high, savings and investment are low, and sustained productivity gains are, at best, elusive. Finally, interest rates remain high and the associated balance sheet pressures on businesses and households remain real.

In that setting, I will confess to a certain trepidation about appearing here with you this morning, in part because I suspect that some of you may look upon the Federal Reserve as the primary cause of the current high level of interest rates. The Federal Reserve undeniably has something to do with the interest rate situation, but I hope to use this occasion to put that situation in its proper perspective and, in the process, shed some light on the causes and cures for high interest rates.

It is not my purpose to speak to you today only about interest rates as an isolated phenomenon, but rather to use this occasion to discuss with you some of the more general economic problems, institutions, and the policies that create, and will ultimately cure, today's high interest rates.

Some of the symptoms of these problems are seemingly conflicting and certainly confusing: the simultaneous occurrence of high inflation and high unemployment; the simultaneous occurrence of low and, in many instances, declining real incomes; the simultaneous and self-defeating effort of all groups to escape inflation by striving to increase their real income -- their "share of the pie" -- at the expense of others.

Other symptoms are less ambiguous. Fifteen years of essentially escalating rates of inflation produced a clear tendency to "buy now" and "borrow now." That tendency produced low savings and therefore low investment, low capital formation, and sluggish productivity, and contributed to the deterioration of balance sheets for both individuals and businesses. Similarly, our markets, whether the market for precious metals, for wheat, or for Treasury bills, have been buffeted by short-run price variability, which, in my view, illustrates forcefully the heightened sensitivity of market participants -- small and large -- to changes in inflation and expected inflation.

At the risk of a gross oversimplification, I think it is fair to say that the symptoms of which I speak can all find their roots in a decade and a half of essentially accelerating inflation. And I would submit to you that the experience of 15 years of

progressively higher inflation was not altogether an accident or an outgrowth of OPEC. In part, it was a reflection of the fact that many, if not most, of us convinced ourselves that we could somehow live with a "little" more inflation. We could somehow isolate or insulate, we could somehow index or subsidize, we could somehow muddle through. Nearly all of us -- economists, journalists, teachers, liberals, and conservatives -- we all accepted that thinking because we believed that the "little more" inflation seemed to buy so much more in terms of lower unemployment and increased availability of goods and services.

Unfortunately, we, like many before us, were wrong. Indeed, in retrospect it is now clear that had we been willing to look hard enough and had we been willing not to delude ourselves, we would have recognized that accelerating inflation is not something that can be lived with. There is no such thing as a "little more" inflation. Inflation is inherently debilitating, and as it grows, the resulting distortions and inequities grow with it. There is no escape -- there is no haven. In short, inflation must be attacked and it must be rooted out. Avoiding that reality only intensifies the problem and increases the pain and discomfort associated with the process. That is why I believe it is so important that we, as a nation, come to grips with inflation now -- now before both the problem and its ultimate solution reach proportions that could make our current difficulties look mild by comparison.

I do not mean to suggest for one minute that this implies that our national priorities and our national policies need be or should be designed to the exclusion of other pressing and legitimate concerns. Certainly there is a long agenda of other priorities which must be addressed. However, I do mean to suggest that we should keep one steady eye on the manner in which our efforts to solve these other problems will either contribute to or detract from the ongoing effort to control inflation.

Nor do I mean to suggest that the task of rooting out inflation will be easy. It will not be. But I do very much believe that we have the knowledge, the tools, and above all, the opportunity to get on with the job.

All of which brings me to the role of monetary policy. I know full well that monetary policy and the Federal Reserve are not easily understood, and I know full well that perceptions about monetary policy can be the subject of heated controversy and debate. That is understandable, for monetary policy -- particularly in a day-to-day operational sense -- is highly complex and is subject to many kinds of misunderstandings. I'm sure you appreciate that. It's also subject to many technical problems and -- I would freely acknowledge -- it may even be subject to some short-run miscalculations on our part now and then. These issues can and should be matters of concern, but they should not stand in the way of an appreciation of the core and essence of our policy.

Simply put, that policy is one that seeks to restrain the creation of new money and credit and, over time bring the rate of new money creation down to a pace compatible with a low rate of inflation. That policy, I firmly believe, is a necessary prerequisite to containing inflation and creating conditions for sustained and sustainable economic growth. It is plain from history -- both here and abroad -- that inflation cannot be turned around in an environment of rapid and un-disciplined growth in money and credit. This is not to suggest that the appropriate monetary policy can or should do the job by itself, but it is meant to say that without that policy other efforts will surely fail. I have no doubt, for example, that a compatible and credible fiscal policy can be a potent and perhaps essential complement to a disciplined monetary policy. Stated differently, an appropriate monetary policy is a necessary but not a sufficient condition for controlling inflation.

What then about interest rates? What then about the claim that the Federal Reserve is the cause of the current high level of interest rates that I know is such a concern to all of you? There is, I must confess, an element -- and I emphasize, only an element -- of truth to that claim. It is true, for example, that our policy of restraining the growth in the supply of money does imply that only a certain amount of credit demands can be satisfied at a given interest rate level. When credit demands are sizable -- and especially when they are fueled by inflation and inflationary expectations -- interest rates will

rise. I wish I could tell you that there was some easy way to avoid or circumvent the resulting problem of high interest rates but, in the short run, I see no such easy solution to the problem.

In fact, in the short run and given some set of overall economic and financial conditions, I can see only three alternatives. First, the Federal Reserve could back off. It could speed up the printing press and push enough new money out into circulation to validate all of the credit demands. That could be done. But I think you recognize as readily as I, that such a response would only fuel more inflation and higher inflationary expectations, and in very short order, higher, not lower, interest rates would result. In short, I don't think much of that alternative.

A second approach might be to try to somehow structure a program of credit controls or interest rate ceilings. On the surface, at least, that idea may seem to have appeal. However, on reflection, it too, I believe, is fraught with problems and doomed to failure. Experience has shown all too vividly that controls don't work; they entail massive governmental bureaucracies and arbitrary and sometimes counterproductive allocations, and they are fundamentally in conflict with the system of markets and free enterprise that is so revered here in the agricultural heartland of America. But there is another and perhaps even more fatal practical flaw with credit controls and interest rate

ceilings. That is, with the advent of high technology in the money transfer business, trying to impose artificially low lending rates by law or regulation would only ensure that money -- which is highly fungible -- would flee to other markets, even to foreign markets. From where I stand, those are not the results we want either.

There is a way, however, that can help to lessen the pressures on interest rates, even in the short run. For example, it is clear that pressures on interest rates would be relieved if the demands for money and credit were more moderate. Unfortunately, such a softening in credit demands is often associated with a fall-off in economic activity -- a process that we saw very clearly in the second quarter of 1980. However, achieving some moderation in credit demand need not be associated with a large decline in economic activity, particularly when we recognize that the government itself and its sponsored agencies are by far the largest single source of credit demand. Indeed, there now seems to be widespread recognition in the Congress and elsewhere that large and persistent patterns of government borrowing work to place upward pressures on interest rates and in the process work to limit the amount of credit that is available to private borrowers -- small and large. This is heartening, for I am convinced that we simply cannot have successive and large federal deficits -- with all they imply for the borrowing needs of the Treasury -- and at the same time expect to meet the legitimate credit demands of businesses, households, and farmers in a climate of moderate interest rates.

Thus reducing and eliminating deficits in the government will work toward moderating congestion in our financial markets and thereby easing upward pressures on interest rates. One should not conclude from this that I believe that we must have a balanced budget or a surplus every year. There may, for example, be periods in which reduced levels of economic activity would justify a deficit. Similarly, one should not conclude from this that I believe that we must immediately balance the budget. To the contrary, in the current setting -- a setting that is already characterized by high and stifling tax burdens, seeking to balance the budget immediately would probably entail unacceptable strains on the economy generally. What is needed in the short run -- and what I sense is beginning to be achieved -- is a firm and credible sense of direction -- a sense that we are moving in the right direction. That alone can unleash expectational forces that can help moderate interest rates, particularly long-term rates which are so critical for housing and other forms of fixed investment.

I said before that none of this will be easy. Certainly the realities of fiscal policy point in that direction for even under the best of circumstances the Treasury will have a major presence in our credit markets for some time to come. That will mean that for the time being the burden of the inflation fight will continue to fall heavily on monetary policy.

In closing, let me also say that I am acutely aware that the burden of high interest rates falls quite unevenly on various sectors of the economy. I am aware of that from looking at economic statistics, but I am even more keenly aware of it from my meetings with business leaders, farmers, ranchers and bankers throughout the Ninth Federal Reserve District. For the nation as a whole and right here in the Dakotas, we have a situation in which some sectors of the economy -- such as energy -- seem virtually immune from the effects of high interest rates. At the same time, other sectors such as home building, automobiles and smaller businesses are severely pinched by high interest rates. Some of these pressures are moderated by instrumentalities such as the Farm Credit System, but even allowing for these programs there can be no questioning the proposition that the burden of high interest rates is far more real for some than for others. I wish I could tell you that there was some way around this problem, but I fear there is not. Nor is there a way we can overcome these larger problems and regain a stable and sustainable pattern of economic growth without incurring some measure of difficulty and strain.

When all is said and done, there is only one sure formula for lower interest rates and that is through lower inflation and reduced expectations of inflation. I said earlier that there were some hopeful signs that the inflation rate may at last be starting to recede a bit. However, I don't think we are yet at the point where expectations of future inflation have begun

to depart from the deeply ingrained view that we are somehow destined to see prices rising by 10 percent per year. Achieving that milestone will be the next critical step on the long and tough road back to a truly prosperous economy. With that goal in sight, it seems to me that now is the time that we should redouble our convictions and our commitment and I, for one, have the clear sense that we are prepared to get on with the job. That sense of optimism grows out of my belief that we have learned from our past mistakes and from my belief that there is a widespread recognition that prosperity -- true prosperity for all -- can only be achieved in a non-inflationary environment. This is the road -- the only sure road -- to lower interest rates.

Thank you.