THE EFFECTIVE APPLICATION OF MONETARY POLICY

Remarks by

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The announced theme of your conference is enough to give pause even to one who cut his professional teeth on the Internal Revenue Code. It is "How to Disinflate Without Deflating an Overexuberant Economy." If I may translate, Mr. Ensley and his associates have really posed two questions: Can we stop inflation without at the same time pushing the unemployment rate up to 5 per cent, say, or even 6 per cent? Are there other constraints than concern about the unemployment rate? I am to tell you, I believe, how I, as an officer of the Federal Reserve System answer these questions.

As to my first question: My difficulty--and in Mr. Stein's presence, I admit this with some reluctance--is that I am unsure that we, the Federal Reserve and the Administration, can stop inflation without sharply increasing the unemployment rate--or pushing it up to a level which, given the present unemployment compensation program, would be socially intolerable. It has been suggested that we can; I hope we can; but I have been unable to rid myself of all doubt.

Postwar experience, of the United States and other western countries as well, suggests that there is an unfortunate relationship between prices and unemployment--an economic law, if you will--which binds the Federal Reserve and the Administration. Simply put, it is this: the lower the unemployment rate, the more rapidly prices increase.

You will recall that the United States had virtual price stability for an extended period from the beginning of 1961, or even before, until mid-1965. But during this period, the overall unemployment rate, while trending down, nevertheless averaged nearly 6 per cent. Since the beginning of 1966 it has averaged only a little more than half that rate, or about 3 1/2 per cent. And over this period, as we are all too well aware, prices have increased sharply. To a first approximation, then recent United States

experience is consistent with that unpleasant but seemingly inexorable economic law I mentioned. It suggests that a return to reasonable price stability could well involve a considerable increase in the unemployment rate, and therefore possibly even more social strife than lately we have had.

The discovery of an apparent relationship between the rate of inflation and the unemployment rate goes back now quite a few years. And for rather a long time after the discovery, until quite recently in fact, economists were pretty much agreed that this relationship was, as they say, stable, and therefore afforded policy-makers some limited freedom of choice. Holding to a particular unemployment rate, 4 per cent perhaps, would ensure a steady rate of inflation of, say, perhaps 2 or 3 per cent per year -- year after year -- indefinitely into the future. Policy-makers could therefore make a choice. They might decide to accept a somewhat higher unemployment rate, and get in exchange a little lower rate of inflation; or they might decide on a somewhat lower unemployment, if they were willing, as it were, to pay the price of a little higher, but still steady, rate of inflation.

There are still many economists, the majority perhaps, who believe that the unemployment/inflation relationship is stable, within some range anyway, and that, in the medium-term at least, policy-makers do have a certain freedom of choice. But increasingly it is being argued that price stability, accompanied by whatever unemployment rate is required (maybe 5 per cent, or even 6), is the only <u>lasting</u> alternative. And why? Simply because if wage earners come to count on further price increases, they will demand still greater money wage increases, with the result that inflation will accelerate. Thus, the psychology of expectations enters the picture and upsets what otherwise might be a stable relationship.

All economists, of whatever persuasion, would agree that runaway inflation is intolerable. But if those economists who believe that any increase in prices is bound to accelerate are correct and price inflation does tend to become self-generating, then there is not only a justification to accept whatever unemployment rate is required to achieve reasonable price stability, there is a compulsion to do so. The argument that policy-makers have no choice, under conditions of inflation such as we are now experiencing, but to allow unemployment to increase is therefore convenient. Moreover, it may also be correct. Possibly it is wishful thinking, but I am still inclined to believe that policy-makers do have at least a limited freedom of choice, but the fact is that, in the United States anyway, we have not had enough experience with inflation to know whether this is so.

Here, however, what is important is that few if any economists would maintain that price stability can be achieved at an unemployment rate of, say, 3½ per cent, which is about today's rate, or even 4 per cent. Those who believe that the relationship between the rate of inflation and the unemployment rate is stable would not maintain this. Nor, so far as I am aware, would those who believe that the relationship is unstable.

I sometimes find myself thinking that any time all, or most, economists are agreed, they are almost certainly wrong. But not, I would bet, in this instance. It seems to me reasonable that if inflation is to be stopped, then a rather considerable increase in the unemployment rate is going to be necessary.

I do not, particularly with this audience, have to go on at any length about the desirability of restoring reasonable price stability. Let

me remind you, though, of what has happened to the United States balance of payments, and more particularly the so-called balance on goods and services. In 1964 this balance was roughly $8.5 billion on the plus side; in 1968 it was a little less than $2 billion. In the first quarter of 1969 it was, for all practical purposes, zero. It would be quite wrong, of course, to chalk up the whole of this decrease to inflation, but certainly a portion must be.

For some, perfectly flexible exchange rates are the way to deal with inflation. No doubt the western world needs greater flexibility of exchange rates, but that it should have perfectly flexible rates is not obvious, at least to me. Anyway, what I would stress is the unfairness of inflation. It is a tax, the incidence of which, so far as I can see, is socially and economically indefensible. Ultimately, this is why we should strive for reasonable price stability.

But if inflation is unfair, so is unemployment. And if inflation can result in social unrest, so can unemployment. Of this we must all be aware.

I may seem to have come round to a rather desperate conclusion: reasonable price stability and full employment are both well-nigh imperative, and yet, as objectives, they may well be contradictory. I want not to believe it. Fortunately we have a few options left, for this country has not done as much as it might to take the sting out of inflation or, more reasonably, out of unemployment.

The Congress has periodically adjusted social security benefits, and in so doing has helped make inflation less inequitable in its impact, at least

for a particular group in our society. I question, however, how much further we can go. We are not altogether sure of what, in detail, the impact of inflation is. We should know much more than we do. But knowing more, I wonder if the government could, or should, do a great deal more than it has to take the sting out of inflation.

It is easier after the fact to identify those who are hurt by an increase in the unemployment rate. Even before the fact, I suspect, identifying those who will likely be hurt is not all that difficult. Not being a labor market expert, I should not sound too confident. But this is my feeling.

What comes to mind, of course, is a considerable expansion of the country's unemployment compensation program. Such an expansion must, however, in circumstances like those of today, be financed by an increase in taxes or, as I would prefer, cutbacks in present low-priority governmental programs, of which there would seem to be quite a few. And I have in mind changing our conception of what unemployment compensation is. For what is the good of a program which compensates only those who have lost jobs, when many who are unemployed have never had jobs to lose? And make no mistake; an increase in the overall unemployment rate is likely to be accompanied by a disproportionately large increase in the unemployment rate for the relatively young, white and black. Rather than simply doling out money, it would be better, of course, to spend it on education for the unemployed. For older workers, doling out money, even for an extended period, may be appropriate. I think not, though, for younger workers. The essence of an efficient Workmen's Compensation Program is the rehabilitation and

retraining of the physically injured worker. It would seem useful to at least explore the same approach to the economically injured worker.

Let me not bore you, however, with details. I wanted only to make a simple point, maybe even an obvious point. There is an economic solution to our stabilization dilemma. It carries a price tag of admittedly unknown amounts in an increase in unemployment. But the fact it exists means it is an inhibitor operating on both fiscal and monetary policy. If we can find ways to take some of the sting out of unemployment, and free up policy makers, stopping inflation will be made a lot easier. It may cost a good deal of money, but inflation is a sufficient evil and our social problems sufficiently pressing to warrant reassessing some of our priorities.

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If you want, you can think of what I have said so far as an elaborate excuse for why has the Federal Reserve System not been more restrictive than it has. I might point out parenthetically though, the last few months have seen an increase in monetary restraint, however defined. Interest rates are higher, on average, than they were at the end of 1968. The rate of growth of the money stock is nothing like as high as it was. Nor is the rate of growth of bank credit. But still one may ask, though, why we have not had an even sharper increase in monetary restraint -- if imaginable, an increase sufficiently sharp to stop the economy dead in its tracks, as it were.

I have spent considerable time explaining one of the constraints which is the realization that a sharp increase in unemployment would almost certainly result from any all-out attempt to stop inflation. Monetary policy has also been constrained, although to a lesser extent, by the knowledge of what happened in 1966. In that context, I should like to say a few words about monetary policy and thrift institutions.

What I argued a few moments ago was that we have to change our unemployment compensation program, and thereby unfetter stabilization policy, or free it so that it can be used vigorously to deal with inflation. And what I shall argue now is that we require a modification of the practices of thrift institutions, so that the Federal Reserve can be freer than it has been to do what the economic outlook seems to demand -- and freer, I might add, to keep the growth of the money stock within reasonable bounds.

We are all familiar with what happened to housing starts in 1966. It is rather remarkable, in light of what happened then, that in April, 1969 housing starts were about what they were in July, 1968. There are probably many explanations: among them, the switch from single- to multiple-family units. Nor can the Interest Rate Control Act, passed in September, 1966, be ignored. The decrease in housing starts in 1966, which began not at the time of the crunch in August and September, but almost six months earlier in March, 1966, must be traced in part to commercial banks having successfully competed funds away from thrift institutions, mutual savings banks and savings and loan associations. This time, however, they have not been able to do so, largely perhaps because of the 1966 law which has prevented them from increasing deposit rates. As a result, the supply of single-unit mortgage funds has not contracted as much as it did in 1966.

It is not slighting the managements of savings banks and savings

and loan associations to say that, collectively, their institutions lost funds to commercial banks in 1966. The competence of these managements is certainly not at issue. There are other reasons. Among those frequently heard is that these institutions lend longer, on average, than do commercial banks, so their portfolio rates of return change more slowly than do those of commercial banks. This undoubtedly explains, at least in part, what happened in 1966 -- why commercial banks were able to gain funds at the expense of savings banks and savings and loan associations, and why a few savings and loan associations, in trying to keep their funds, almost went under.

What I cannot grasp, however, is why their lending longer, on average, than commercial banks means that savings banks and savings and loan associations can never compete successfully for funds during periods when interest rates are increasing. Or why their lending longer, on average, means we need to regulate rates paid by thrift institutions, and stifle competition. As a supporter of the market place, I must confess to not liking the Interest Rate Control Act, although I did in 1966 see the need for temporarily limiting competition. What I am not persuaded of is the long-term need for the Act.

The point is surely that if savings banks and savings and loan associations are relatively bad off during periods when interest rates are increasing, they are relatively well off during periods when interest rates are decreasing. Unless it is insisted that there is a trend to interest rates, then over the cycle these institutions are not, by virtue of the kind of loans they make, at any competitive disadvantage.

It might help if thrift institutions were able to diversify their liabilities more than they have, and lengthen their average maturity. It might also help if they were able to diversify their assets, and perhaps shorten their average maturity. It is not inconceivable some totally new approaches might not be useful. At the risk of raising a few eyebrows, I might suggest securing authority to make variable-interest mortgage loans. Or authority to pay out on occasion more than they earn. This would also require, on occasion, paying out less than is earned, so that, on average, no more would be paid out than is justified by what is earned on loans. Financing could be required, of course. Thrift institutions might have to pay more attention to liquidity. But to repeat, what is fundamental is that thrift institutions be enabled to take the long view. If they do, then governmental agencies will not need to regulate interest payments, which I dislike our doing. And the Federal Reserve will be able to tolerate greater fluctuations in interest rates, as it must if it is going to pay more attention to how the money stock behaves and if, as I hope, we are sometime going to try to get by with fewer direct controls on international capital flows.

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It was not my intention to come here and, as the saying goes, leave you laughing. I have not meant to be outrageous, but rather responsibly provocative. I hope I have given you something to think about.

It turns out that I have been faithful in a way to the title Mr. Ensley gave me. I have talked, if not about what effective monetary policy is, then about how monetary policy can be made more effective -- or how it can be freed from some of the present constraints. The important thing, it seems to me, is to do just that. The Federal Reserve does not lack the will.

It is just that its world is very complex, more complex than that of its critics. But with certain changes in institutions, its world would be simpler and it would be freer to seek reasonable price stability and a more satisfactory balance on international account.