THE ROLE OF MONETARY POLICY IN A SHORTAGE ECONOMY

Remarks by

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If there's one word that characterizes the outlook for the economy over the next year, that word is "uncertainty". Private forecasters are hedging their bets even more than they usually do, and Herb Stein, the Government's top economist is busily assuring Congress that the Administration intends to stay loose -- I think his phrase was "remain flexible" -- in case the second half upturn doesn't turn up.

In fact, what's most surprising under the circumstances is that the forecasts seem to cluster in such a narrow range. One wonders whether the first man off the mark didn't just toss a dart at the circle, and everybody else grabbed the same set of numbers on grounds that they were as good as any others.

The standard profile foresees one or two quarters of negative real growth in the first half of the year, followed by a pickup in the second half of varying dimensions. Expectations of resumed growth rest on the belief that plant and equipment expenditure will remain strong, that housing outlays will be accelerating, and that auto sales will have recovered from the disastrous slump of the early part of this year.

Despite this slow growth and expected rise in unemployment, there will apparently be little if any relief from the rapid pace of price increases that we've experienced in recent months, at least for the first half of the year. The present higher costs of energy have by no means yet worked through the pricing structure. We are evidently facing another bout of increased prices for agricultural commodities, both grains and meats. And it's hard to believe that the ending of price and wage controls this spring won't give some additional kick to the cost of living.

It's difficult to find much that's comforting to say about this kind of economic outlook. And the frustration is all the greater because policymakers feel trapped with no good options. In these circumstances, the Administration's budget proposals seem as well tailored as could be expected to the uncertain needs of the economy. The projected increase in expenditures of about $30 billion represents a rise of some 11 percent, more than half of which could be chewed up by rising prices. With a slowing economy holding down revenue gains, the Administration is expecting the budget deficit to double, from about $5 billion to $10 billion.

Probably the greatest risk from the fiscal side is that this deficit figure could increase substantially. Administration spokesmen have made it clear that they would quickly loosen the pursestrings if the economy appears headed for a deeper downturn than they now expect. And certainly the Congress, despite welcome progress in devising a more orderly appropriations process, is likely to lead the parade toward larger expenditure totals in several areas. With the spur of rising unemployment and the absence of last year's strong restraint from the White House, the Congress could add sizably to outlays.

The dilemma of a sluggish economy, afflicted with severe sectoral disturbances, shortages, and rising prices also made difficult the recommendation to let lapse the system of wage and price controls. Yet, with some relatively minor differences on details, there seems to be a clear consensus that these controls were no longer effective, and in a number of instances were actually counterproductive.

In agreeing that the time has come to free most industries from controls, I cling to the belief that Phases I and II did provide a measure of relief from the problems of stagflation under which the economy was laboring in 1971 and 1972. There are those who argue that wage-push inflation was slowing anyway, and that the freeze was therefore redundant, giving the illusion of success without much substance. My own reading is that the country got a real psychological boost from strong action by the Administration to help propel us out of the doldrums. Indeed, if there is a general criticism of the wage/price control program, it is that it was instituted a year too late, and phased out too slowly as we approached capacity limitations. At best, wage/price restraints can only be effective in a demand-slack economy, serving to break into and short-circuit a price-wage spiral, and thus permit stimulative policies to be undertaken sooner than otherwise possible.

It's always easier to comment on policies for which one is not directly responsible, than on one's own. But the same conflicting and uncertain circumstances that make economic policy decisions difficult for the Administration at the moment also pose a dilemma for monetary policy. If we take for granted that there will be a substantial slowing in output and employment over the months ahead, the gut question is whether that slowdown can be ameliorated by an easing of monetary policy, or whether such easing would simply exacerbate upward pressures on wages and prices with little or no effect on employment.

Although I put the question in "either/or" terms, obviously the answer is not either/or, but rather one of degree. Those who feel that the main constraint on economic activity in coming months will derive from capacity limitations (i.e., the inability to produce the goods desired) see little point in easing credit significantly. It is pointed out, for example, that even as we enter a period of slowdown, we are still bumping against supply bottlenecks in a number of key sectors. In the specific case of petroleum shortages, the potential impact is pervasive and, because of the embargo, unpredictable. Specific industries and regions of the country are being, and are likely to be, much harder hit than others.

If these are the salient features of our predicament, then a generalized easing of credit would truly be of little help. A much more selective approach through targeted employment and unemployment programs would seem far preferable, putting financial assistance where it's needed most rather than spreading it around to fuel price increases in supply-short industries.

Without denying the validity of these points in any way, I think one can postulate a different scenario that would lead, on balance, to a different conclusion. This scenario would begin with the assessment that a cyclical slowdown was already underway last fall before the announcement of the oil embargo. Consumer sentiment as measured by the various surveys had turned pessimistic by mid-year, and retail sales -- in real terms -- had been sluggish for some months. The embargo, according to this reasoning, simply compounded and hastened a "correction" that was already underway. It did so by magnifying uncertainties about the future many fold. Even though present estimates of petroleum shortfall are reduced from a couple of months ago, the headlines are telling us with disconcerting regularity of layoffs in the auto industry, the airlines, service stations, recreation and travel sectors, etc. Even though the actual numbers of people put out of work may not be large -- though it's certainly not trifling -- the psychological impact of the announcements on consumer confidence must be substantial.

Even if we have no concern about our own job security, all of us are being affected by the unprecedented price adjustments that we face in the grocery store and at the gas pump. We've read that real disposable income has been declining through most of 1973, as price increases outpaced wage settlements. But frankly, we don't need to read that bit of news -- it hits too close to home in our daily experience: we know we've got less to spend, and we're cutting back accordingly.

As always, one could cite evidence on several sides. But the argument from this line of reasoning is that the slowdown we face is more likely on balance to be characterized by inadequate demand than by inadequate supplies. If this is the case, then we are back in the typical cycle -- admittedly with some very odd and disconcerting accoutrements -- where some credit easing would be appropriate.

But even if this argument is persuasive -- i.e., that we're in, or shortly going to be in, an economy with inadequate demand -- one can't be sure of those facts, but one can be sure that prices are jumping higher at unprecedented rates. How can the monetary authorities countenance a policy of easing in the face of that hard evidence of unrestrained inflation? The answer, again a matter of judgment, turns on how one views the present situation: is monetary policy in the current circumstances likely to have a greater impact on real output and employment, or on prices and wages? If one thinks, as I do, that the major impetus to price increases at the moment is a once-over adjustment to higher energy costs and higher agricultural prices based on changed supply schedules, then the most that continued monetary restraint could do would be to inhibit the transmission of these increases into wage bargains by permitting unemployment to increase marginally. Frankly, there is little evidence that marginally higher unemployment has much of a deterrent effect on wage settlements "justified" as inflation catch-ups.

The record of policy actions by the Federal Open Market Committee shows that the Federal Reserve has in fact already moved away from the degree of restraint that was its policy stance last summer. Looking back over the intervening months, one can see that the growth in the monetary aggregates (using quarterly averages) slowed noticeably in the final quarter of the year, and that the aggregates were distinctly weak in January. At the same time, short-term interest rates were edging downward, with the Fed funds rate, for example, dropping from a 10-1/2 - 11 percent range in late September to around 9 percent at present.

But it's always difficult to distinguish policy-induced effects on the financial variables from those feeding back from changes in the real economy. This is as true, unfortunately, for the monetary authorities as it is for outside observers. The only information available to policymakers that is not available to the market, presumably, is the Fed's own current intention with respect to future restraint or easing. And even in this area, the market thinks it is becoming super-sophisticated in reading the signs of policy shift.

In this connection, I'd like to quote a few excerpts from an interesting analytical piece by Al Wojnilower of First Boston Corporation last November entitled "A New Monetary Environment":

> "The trouble is that everyone in the market can understand and predict -- at least we think we can -- how the Federal Reserve will be reacting to the weekly money supply figures as they emerge. This early warning system for the market provides in much the same way as does the promise that there will be no credit crunch, a destabilizing removal of uncertainty. When money supply is rising too fast, we are confident that soon the Fed will tighten its money market stance and certain that it won't ease; if money is expanding too slowly, on the other hand, ease must be on the way and tightening is out of the question. In the past, when money supply growth accelerated, interest rates would initially fall. Now they tend to rise, because the market knows that faster growth of money supply leads promptly to a more restrictive official stance. Conversely, interest rates used to

rise when money supply decelerated, but now they fall because we know that deceleration of money supply leads to an easier Federal Reserve posture. . .

"When it is possible for the market to feel certain, on the basis of the trend in money supply, of the direction of Federal Reserve policy toward short-term interest rates, the commercial banking system can and will blow up the balloon of time deposits and business loan demand and then let the air out again, in a game almost completely divorced from any relation to the real economy. . .

"This new sense of knowing the monetary authorities better than they know themselves, coupled to new technologies of instant news transmission, has substantially changed the culture of our money and bond markets. . .

"In the past, when the authorities were thought to have in mind a band of interest rates that they considered appropriate to the business situation, and that they shifted only gradually with the outlook, the market was understandably cautious about moving prices so violently as to challenge these limits. The most successful market practitioners were those who were in tune and comfortable with the official perception of the world. But now that these interest rate boundaries are vague or absent, the market rewards a different type of trader. With short-run Federal Reserve policy governed by the behavior of monetary aggregates under seemingly transparent rules, practices are spreading that parallel the exciting performance of the over-the-counter stock markets of the late

1960's. We have to get used to the idea that it is entirely logical for markets to race off in one or the other direction, when traders can be confident that their sheer energy can drive prices a long way without fear of colliding with so-called 'fundamentals.'"

I think there is some truth to the point Al makes -- namely, that fluctuations in short-term interest rates are likely to be wider in a regime where the Fed is placing more weight on getting the monetary aggregates to track a desired path, than under the previous regime of largely interest-rate guided policy. This greater scope for rate swings in fact probably has two time dimensions -- first, the range of rate movement that can be expected between FOMC meetings, and second, the range of movement over a longer period of several months.

If one is serious about trying to induce more or less stable growth in the money supply, as I am, then one must be prepared to sacrifice to some extent interest rate stability. And I think it's also true, as Al states, that if the public knows the procedures by which the Fed implements its policy prescriptions, the market is likely to anticipate rate movements, and quite possibly try to run ahead of our intentions. Yet neither of these facts, in my mind, justifies abandoning our emphasis on the aggregates, nor trying to cloak our procedures in mystery. On the contrary, I believe that if the market were more fully aware of our operating techniques, they might be less inclined to run too far in any particular direction.

For this reason, I'd like to spend just a moment describing how I see the Fed's policy intentions translated into market actions. I'm sure you could get a different emphasis, if not different story, from other members of the

Committee, so don't assume you're hearing the only interpretation of how we go about our business. Moreover, mine will be a conceptualized description, without pretending to be complete in technical detail.

With these caveats, I see the process beginning with the selection of a longer-run growth path for the aggregates (normally symbolized by M_1), a path thought to be consistent with the needs of the economy over the quarters ahead. In the current context of rapidly rising prices, one is already in some difficulty in deciding whether that path should be geared strictly to potential growth in real terms, or whether some part of anticipated price increases should be allowed for, or as some would say, "validated."

Once such a longer-run path is selected (note that it's not a "forever" path of 4 percent, or any other number), a shorter-run two-month horizon is specified, not as a single target rate, but as ranges of rates for different aggregates, reflecting our well-proven inability to control precisely the aggregates over any short period of time. Paralleling these target ranges for the aggregates is a range of permissible variation for the Fed funds rate. In concept, as the aggregates deviate from the midpoints of their specified short-run ranges, the manager of the open market desk is expected to inject or withhold reserves without, however, permitting the Fed funds rate to move outside its predetermined limits.

In practice, the range of permitted movement in the funds rate between monthly meetings, while varying from time to time, has usually been on the order of 1 - 1-1/2 percentage points. Since the prevailing funds rate is normally inside the specified limits at the time of their adoption, the potential movement of the rate in any four-week period is not likely to exceed 1 percentage point even if the aggregates, as they become known, appear to be falling outside their designated ranges. Nor is it contemplated that the rate would bounce from one end of the range to the other from week to week. As is apparent from the record, the adjustments are fairly smooth over the inter-meeting period, with movements in the rate (on a weekly average basis) rarely exceeding 1/4 percentage point.

Even with this gradualist approach to funds rate movements, an approach designed to prevent short-term rates from swinging needlessly or disruptively in response to erratic week-to-week fluctuations in money supply numbers -- it would theoretically be possible for the funds rate to move as much as 6 percentage points within the space of six months if the aggregates were persistently falling outside their desired limits.

Although the conceptual framework I've just described could be applied in a quite mechanical manner, the fact is that the Open Market Committee does not operate that way. Only after a full discussion of the relevant economic and financial information does the Committee select specifications for the short-run aggregates and funds rate range designed to nudge the aggregates back toward the desired long-run target at greater or lesser speed. Thus, for all our efforts to explain what we think we are doing, and how we are going about it, there will inevitably -- and, according to Wojnilower, desirably -- be an element of uncertainty as to policy stance at any given point in time. Moreover, actual desk actions will be guided not just by intended policy, but also by the interaction between intended policy and the week-to-week behavior, often quite erratic, of the monetary aggregates.

I'd like to add one final word about monetary policy in the months ahead. I started out by saying, as others have, that uncertainty is the key feature of our present outlook. Uneasiness might even describe the feeling better. Past guideposts seem unavailing or absent in the world of today, and lack of confidence is pervasive. In this kind of environment, I think there is something to be said for a "traditional" response by the monetary authorities to signs of slowdown, even if on intellectual grounds a case could be made that this slowdown is of a nature that won't be helped by monetary ease. In effect -- and I wouldn't want to press this point too far -- I think that we might only compound uncertainty, at least among the unsophisticated, if we persisted in a policy of restraint when people were losing their jobs.

In closing, I'd like to quote a beautiful disclaimer I saw on a recent outlook paper from an investment banking house. Perhaps it's standard boiler plate, but I hadn't noticed it before, and I think it's quite applicable to what you've just heard.

> "This material is for your private information, and we are not soliciting any action based upon it. Opinions expressed are our present opinions only. The material is based upon information which we consider reliable, but we do not represent that it is accurate or complete, and it should not be relied upon as such."