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Statement by  
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Mr. Chairman and members of the Inflation Task Force, I am pleased to have the opportunity to testify today on credit controls and inflation. All of us here today would agree that reducing inflation and avoiding a serious recession are the major objectives of economic policy today. The debate then is not about where we want to go but rather about the best way to get there. I wish I could assure you that credit controls would be a practical way to reach our objectives, or at least a step in the right direction. Based on considerable research and analysis, however, I am convinced that credit controls are counterproductive policy tools.

Economists at the Federal Reserve Bank of Minneapolis have, since early in this decade, been conducting research that has resulted in a serious challenge to the traditional ways government conducts economic policy, including anti-inflation policy. Among other things, we have investigated past inflationary periods in our country's history and current stagflation. We have also tested different theories of how the economy works and have developed new theories and new economic models that, we think, can better explain both inflation and fluctuations in economic activity.

Obviously, we have not done this single-handedly. We have made use of the scholarship of some of the best economists from around the world. Together, we believe we have made significant contributions toward understanding inflation and its causes and have reached some conclusions that only a few years ago would have sounded like heresy in almost any economics department in this country. Although our conclusions are still controversial, they are rapidly gaining acceptance. More importantly, they are entirely consistent with the facts and the basic assumptions that have been the foundation of economics for 200 years, which is, surprisingly, more than can be said about many current explanations of inflation.

The assumptions we make are straightforward and familiar. Our basic assumption is that people act in their own best interests, that they try to get the most

psychological or material benefit from the resources available to them. A related assumption is that people use available information to derive the maximum benefit or, in other words, that they use information efficiently. When a large population is involved, this means that people make random errors in predicting future trends in inflation but that they are correct on average. That is, they cannot be repeatedly and systematically fooled about government policy unless they lack important information or do not act in their own best interests.

Starting from these assumptions, our research has led to two main conclusions. The first is that we don't have to create a recession in order to control inflation. That is, the so-called trade-off between inflation and unemployment is not chiseled in stone. Thus, it comes as no surprise that the sustained inflation of the 1970s was accompanied by higher, and not lower, rates of unemployment.

For the same reasons that we now have high inflation and high unemployment, we could have lower inflation and lower unemployment. With moderate, credible, and well-understood monetary and fiscal policies, in other words, we can lower inflation without causing more permanent unemployment. Of course, a recession is still a danger that must not be overlooked in setting economic policy, but it is not necessary or desirable for restraining inflation.

The second main conclusion that our researchers have reached is that the cause of inflation is not what most consumers and voters believe it to be. Labor unions aren't the main cause of inflation. Big businesses aren't the main cause of inflation. Greediness or live-for-today attitudes aren't the main cause of inflation. Failures in Presidential jawboning, wage and price controls, or the Energy Department aren't the main cause of inflation. Even OPEC is not the main cause of inflation. Many countries, such as Germany and Japan, import proportionately more oil than the United States and still have much lower rates of inflation.

While these things may aggravate inflation, particularly in the short run, there is no doubt that government is the main cause of inflation. That is, government policies that let the money supply grow too quickly and too sporadically, and that let federal deficits get too large for too long, are the underlying causes of inflation.

These two conclusions--that a recession isn't essential for fighting inflation and that government causes inflation--have direct implications for credit controls. They indicate that more restrictive controls on private credit transactions are the wrong way to fight inflation and could easily be counterproductive. Credit controls can actually make inflation worse.

Certainly, the proponents of credit controls would disagree with this. They usually argue that credit controls can help fight inflation by improving productivity and reducing excess demand. But I feel strongly that these controls couldn't really do the job.

Take, for example, the notion that credit controls, by prohibiting "unproductive" loans and channeling the funds to more productive uses, can help ease inflationary pressures. The first problem is that defining a productive loan is all but impossible without being arbitrary, subjective, or unfair. For instance, loans for producing food, clothing, and shelter are certainly essential, but what about loans for candy, disco pants, and home bars? The regulators would have to distinguish between essential foods and junk foods, between everyday clothing and glad rags, and between necessary and frivolous construction. August committees might debate whether a breakfast cereal that is 40 percent sugar is a food or a candy, a productive or a nonproductive good. Even a basic crop like wheat could not clearly be categorized as productive if there was a wheat surplus. No matter how competent the regulators might be, defining a productive loan would be a futile exercise.

Defining a nonproductive loan would be just as hard. It is common, for example, to simply presume that loans for takeovers or mergers are not productive. But new executives might be able to manage a company's resources more efficiently than the

old ones, thereby increasing productivity. In addition, sometimes the mere threat of a takeover motivates the managers to operate more effectively. Besides, the money from a takeover or merger doesn't disappear. It is invested or spent and probably finds its way into productive use, whatever that means. Defining a nonproductive or a productive loan would be an overwhelming task.

In any case, restricting loans to any one category is hard, because money is so fungible. If a given company wants to buy a "nonproductive" company yacht, for instance, it can take out a loan for carrying inventories and thus free other funds for the yacht. Putting barriers in the flow of credit, therefore, is not likely to accomplish anything useful. Putting up barriers, however, does cost the government something. And getting around the barriers costs consumers and businesses something. Credit controls, in short, are not free. As they raise the price of credit-related transactions, they aggravate inflation. The burden of the extra costs of credit controls falls on low-income families and small businesses, who have the fewest liquid assets and are least able to find alternative financing.

There are similar problems in trying to use credit controls to moderate inflation by restricting demand for goods and services. Interest rate ceilings or other restrictions on small consumer loans, for example, fail to lower interest rates or to regulate aggregate demand. When the market rate for loans rises above the legal ceiling, the loans become extinct, because creditors do not want to make unprofitable loans. But creditors don't just sit on their money; they invest it in the markets where ceilings do not exist.

Likewise, in most cases, usury ceilings on conventional mortgages fail to reduce interest rates or aggregate demand significantly. Even though mortgages become more difficult to find, mortgage borrowers are resourceful enough to turn to FHA mortgages, to those guaranteed by the Veterans Administration, or to sources not regulated by usury ceilings. These modes of financing are generally less desirable than

what they replace. For most people, when all costs are taken into account, the alternative means of financing turn out to be more expensive. So once again, credit controls of this type raise prices on average but do not significantly reduce demand.

Of course, some credit controls, if sufficiently Draconian, could reduce aggregate demand. Low ceilings on the interest rates financial institutions can pay their depositors, in the past, have caused funds to leave savings institutions and made mortgages more difficult and more expensive to get, ultimately putting the squeeze on the housing industry.

Such a shock to the housing sector, to other sectors, and to the whole economy can indeed precipitate a recession and temporarily restrain inflation. But two side effects make this an ineffective remedy for inflation. First, periodically tearing down and then rebuilding the housing industry is wasteful and inflationary over the long run. Uncertainty about when and how much the low interest rate ceilings will affect the housing market creates an added risk and hence an added cost that the industry must face. It will eventually lead to higher prices. A second side effect is that the recessions precipitated by tearing down the housing industry virtually guarantee that the government will pursue stimulative monetary and fiscal policies. These policies, after all, are the main causes of inflation. So for economic and political reasons, using credit controls to dismantle housing, or any other sector, will be likely to cause higher, not lower, inflation.

As a means of fighting inflation, then, credit controls are generally unacceptable. Happily, they are also unnecessary. The best way to fight inflation--the least expensive and the most enduring--is with well-designed monetary and fiscal policies. If such policies are well-publicized and well-understood, they do not need to disrupt the economy to be effective. They can lower the rate of inflation without putting people out of work.