MONETARY POLICY IN A "NEW" ECONOMY

by

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It now seems fairly clear that the economy in 1974 will experience a marked slowdown. All the while prices seem likely to be increasing at an unacceptably rapid pace. Perhaps the most pressing economic question now and for the seventies is what to do about an inflationary bias that persists whether the economy is slack or booming.

I want to approach an answer to this question by trying to answer two others: Do we confront a new kind of economy in which the old solutions are ineffective? What is the role of monetary policy in an economy with an inflationary bias?

A "New" Economy

The standard argument for a new economy is based heavily on the premise that both big business and big labor have the economic muscle to escalate wages and prices unaffected by the fact that a substantial amount of productive plant and labor may be unemployed. In this kind of economy, business offers slight resistance to wage increases because the additional cost can be passed on easily, Then as prices rise, labor demands cost-of-living adjustments, business responds, and so on. Expectations of more inflation become self-fulfilling. The argument concludes that in this environment monetary policy cannot be effective short of a deep and prolonged recession.

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The "Old" Economy

Taking strong issue with this position are those who hold that the old economic laws haven't been abrogated. The fault lies with policymakers who keep the money spigot open too wide.

Their argument goes like this: Over the long run, inflation is primarily a monetary phenomenon. The more money pumped in, the cheaper it becomes. Increases in prices and wages can't be sustained unless validated by monetary expansion. This argument draws on statistics that indicate an historical relationship between growth of the money stock and inflation. More recently, in about the last decade and a half, the money supply (M_1) grew about two and a half percent a year up to 1965, and we experienced substantial price stability; since 1965, growth in money has shot up to nearly six percent a year and prices have shot up as well.

This argument concludes that the old economic laws are intact. Therefore, the old monetary tools should still work.

The Constrained Policymaker

Who is right? I give the "old-laws" school high marks for economic logic and the "new-economy" adherents high marks for economic and social realism. My main thesis, in short, is that the old monetary tools are as effective as ever, but that they are more difficult to apply because of the tough constraints society now places on public policymakers. Let me cite three of these constraints.

Unemployment. The nation has always placed low unemployment among its most important economic goals. In recent years, however, our concern for the unemployed has risen. We now see

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unemployment more as a social than an individual failing. We have a new attitude toward the poor and minorities who suffer more from general unemployment.

Because of the growing concern over the costs of unemployment, the Fed probably has followed a more expansionary policy than it otherwise would, and this has complicated the problem of dealing with the bias towards inflation.

Uneven impacts of restrictive policy. Restrictive policy does not affect all sectors of the economy equally. Monetary policy hits some high-priority sectors--notably housing and municipalities--particularly hard. This was the case in both the 1966 and 1969 tight-money periods and, so far as housing is concerned, is the case today. The Fed has been understandably more reluctant to restrict growth in money and credit for fear of the severe effects on areas of high social priority.

Interest rates. Low interest rates have long had popular political appeal. Recently, the Fed has been very much aware of this, as other forms of income, like wages, have been under direct Government controls.

What Can Monetary Policy Do?

In short, the inflationary bias in the U.S. economy can be traced to some extent to growing concern with other economic and social goals. Since these are goals that are likely to remain with us, we do, in fact, have a new economy. An important problem of the rest of the seventies will be how to resolve the tension between these goals and price stability. As I see it, the process requires a three-pronged effort.

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1. The public will have to lower some of its expectations.
2. The economic structure will have to be reorganized so the economy is better able to meet the new demands.
3. Authorities should seek new tools.

Public expectations. Part of the conflict between price stability and other goals can be resolved by the public deciding to give up something. Bringing inflation under control is not costless. One cost is unemployment. I don't see how inflation can be overcome without having--in the near-term, at least--higher unemployment than any of us would like. Another short-run cost is high interest rates during and after periods of monetary restraint. If the inflationary bias in the economy is to be rooted out, the public will have to be persuaded to relax its demands for low unemployment and low interest rates. It must also be persuaded to be patient. The economy does not respond immediately and perfectly to monetary policy. Expectations of quick success may lead to frustration which encourages desperate and ill-conceived policies.

Structural changes. A second solution is to change the structure of the economy so as to improve the chances of achieving all our objectives.

In time, we should be better able to have low unemployment with stable prices by oiling the workings of the labor markets. Frequently people are unemployed even though jobs are available. By providing education and job training to match skills to tasks, and better information to get people and jobs together, we can make substantial progress toward lower long-run unemployment. In addition, more flexible minimum wage legislation would allow those particularly

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prone to unemployment--such as teen-agers--to offer their services at lower wages and so be more likely to find jobs.

Unduly severe impacts of tight money on particular sectors of the economy can be reduced by structural improvements in credit markets. Usury ceilings and restrictions on the activities of specialized lending institutions interfere with the allocation of funds and put certain sectors of the credit market at a competitive disadvantage. Implementation of the Hunt Commission recommendations would help to correct some of these shortcomings.

New tools. A third approach to stable prices without giving in too much on other goals is to seek new tools. Two examples are selective control of resource allocation and incomes policies.

Selective control of resource allocation is hardly new. We have long used the tax structure, for example, to encourage or discourage production in particular sectors of the economy. We have had selective controls on credit for the purchase of stocks, durable consumer goods, and housing. These should be reexamined. It is interesting to ask, for example, whether consumer credit controls might have dampened the recent consumer spending boom. Another possibility is selective credit controls that could insulate the housing market from the extremes of tight credit. One suggestion has been to place reserve requirements on various forms of bank assets that can be moved up and down as one or another form of credit is to be encouraged. Another is to give tax breaks to income derived from such sources as interest on mortgages.

Tools designed to alter resource allocation have many potential problems as well as benefits. Interference with free choice,

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difficulties with bureaucratic administration, and so on, are all widely recognized. Nevertheless, given the existence of strong social priorities, this device seems to have enough merit to warrant further study and experimentation. If allocational priorities can be achieved through selective policies, some of the burden will be taken off the more traditional broad-based tools of monetary policy.

Incomes policies offer some promise, but present enormous problems. Certainly, to the extent they are successful, they take some of the burden of restraint off of monetary policy. This removes some of the pressure on interest rates and housing and municipal markets. But recent experience reveals the difficulties. One is the counterproductive expectational and catch-up effects. Inflation soars when easy "phase" follows tough "phase." Another is the effect of direct controls on normal supply and demand relations which result in shortages. In order to avoid this problem, controls will have to keep a lid on the average price level while not distorting relative prices.

Once the worst of the inflationary bias is squeezed out of the economy, some sort of wage-price guideposts, such as those attempted in the early sixties might prove feasible. But in any event, it is important to recognize the inherent limitations of direct controls. At best they can shorten the lags that link growth of the money supply and excessive demand to price increases. At worst, they will collapse if monetary policy is overly expansive.

Conclusion

Let me sum up. One reason it is now more difficult to subdue inflation is that this goal conflicts with other goals more

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sharply than in the past. Low unemployment is a more pressing economic and social goal, and the uneven impact of tight money is higher in the social conscience than, say, two decades ago. These higher expectations of the economy produce an inflationary bias because policymakers are more constrained in resisting inflation than they once were. To reduce this bias, we either have to lower our expectations, improve the structure of labor and credit markets, or explore other tools. I believe we should forge ahead on all three fronts during the seventies. But we should not kid ourselves into believing that adjusting upward what we can accomplish and downward what we want from the economy will be without frustrations.

In this frustrating situation, the Fed has unique responsibilities and opportunities. It has a responsibility to use its major tool of policy--the control of money and credit--in a manner that will squeeze the inflationary bias out of the economy. This means avoiding extremes on the up-side but also sharp movements on the down-side. Steady growth of money at moderate rates perhaps can do more than any other single policy to bring the economy closer to price stability.

In its position of independence from partisan politics, the Fed has unique opportunities. It is better able to pursue policies that may have unpopular effects, such as high interest rates. It is better able to withstand criticism when policies force a revision in the public's expectations. And it is better able to take the long view and to exert the kind of persistent influence that will be necessary to solve the deep-seated problem that inflation has become.

At the same time, the Fed is in good position to explore

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different kinds of solutions and to experiment with new techniques that may help to make progress in achieving all our objectives. The new demands put upon our economy are not likely to go away. We will have to use our imagination to meet as many of them as possible.

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