FEDERAL RESERVE BANK of PHILADELPHIA

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David P. Eastburn, president of the Federal Reserve Bank of Philadelphia, today made the attached statement before the Committee on Banking and Currency of the U. S. House of Representatives in Washington, D. C.

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STATEMENT

BY

DAVID P. EASTBURN, PRESIDENT

FEDERAL RESERVE BANK OF PHILADELPHIA

BEFORE

COMMITTEE ON BANKING AND CURRENCY

U.S. HOUSE OF REPRESENTATIVES

WASHINGTON, D.C.

July 17, 1974

I welcome the opportunity to be with you today. When Congress created the Federal Reserve System over 60 years ago, it was fearful of too much power concentrated in too few hands. Thus, it wisely established a decentralized central bank with powers shared by a seven-man Board of Governors in Washington and 12 regional Banks throughout the country, all outside the executive branch. But this organizational arrangement in no way was intended to reduce the accountability of the Federal Reserve to Congress. We are a creature of Congress and accountable to it. I think it is most appropriate, therefore, that Federal Reserve officials testify frequently before the various Committees of the Congress and also that from time to time you hear from the Presidents of the various Reserve Banks.

I should like to talk briefly about four closely related problems: 1) causes of inflation; 2) what to do about inflation; 3) the role of interest rates; and 4) evening out the burdens of fighting inflation.

1) Causes of Inflation

If we could somehow create an economic discomfort index the way weathermen combine temperature and humidity, I suspect we would find ourselves about as uncomfortable as at any time in recent years. Prices are soaring, the unemployment rate is creeping up and interest rates are at record levels.

Without minimizing any of the difficulties we face, I believe the major problem is inflation. We are in perhaps the worst peace time inflation in our history. Unless we begin to unwind inflation, I am fearful of the consequences not only for the economy but for our entire social fabric.

Our current inflation has many causes, but it is helpful to divide them into two main aspects. One aspect involves extraordinary events such as crop failures, oil embargoes, and dollar devaluations. They come and go and

often not much can be done about them. Beef prices skyrocket then taper off; wheat supplies diminish then expand; anchovies disappear from the coast of Peru and then reappear. If we are lucky, these phenomena occur at different times. In the last couple of years we have been unlucky; many extraordinary events have occurred together.

A second aspect is monetary. Whatever immediate events may cause prices to rise--including shortages and higher wage costs--a higher price level cannot be sustained without sufficient money. In retrospect it would have been better if money had not grown so rapidly over much of the past decade. The reasons for this growth go to a large extent to considerations other than inflation which the Federal Reserve has believed to be important. Throughout much of the period there was primary concern about the disadvantaged--those unemployed, living in dilapidated housing and attending crowded schools. Ample growth in money was necessary to meet these economic and social problems. In more recent periods, the Federal Reserve, partly reflecting views of Congress, has been concerned about the effects of high and rising interest rates. Still more recently, concerns for the stability of financial institutions have come to the fore.

Whatever the reasons, the consequence of this history is that we find ourselves with rapid increases in both prices and money. The question is how to deal with them.

2) What to do about Inflation

There are no quick or painless answers. Inflation has taken nearly a decade to build up and will take considerable time and discipline to unwind. There are, I believe, four essential requirements for dampening inflation:

First, we have to become more realistic about our capacity to fulfill

our wants. There has been a tendency in recent years to pass over a hard fact of life--scarcity of resources. We simply cannot fulfill all desires, for all people, all at once, although we may earnestly wish to do so. Scarcity is still with us even in an affluent society.

A second requirement for fighting inflation is a firm handle on fiscal policy. In this regard, Congress is to be congratulated in passing the recent budget reform bill. This legislation can give Congress the kind of control that is long overdue.

Third, I believe there is a limited role for an incomes policy. We've just been through 32 months and four phases of controls and the economy has just plain had it with controls for awhile. But there could still be a useful role for monitoring and publicizing key wage and price decisions.

Finally, we need to keep a firm grip on money and credit. History teaches two lessons about the impact of monetary policy. One is that inflation cannot continue without the money to finance it. Therefore, if inflation is to be moderated, growth in money must also be moderated. A second lesson is that growth in money must be moderated slowly to avoid sending the economy into a serious recession.

Translated into current policy, these lessons mean that the recent seven percent growth in money (the narrow money supply or M_1) must be moderated over a period of time, and the time could be quite long. I believe it is important, therefore, for the Federal Open Market Committee to set long-run targets for moderating growth and then diligently pursue hitting these targets. In fact, the FOMC has been attempting such a procedure for over two years now. I'm hopeful that with experience and resolve we'll be able to improve the accuracy of our aim.

3) Role of Interest Rates

What would such a policy mean for interest rates? I am uncomfortable with high interest rates, especially with the record levels we are currently experiencing. But we should be clear about two things: one is what is necessary to bring interest rates down; the other is the role which interest rates play in combatting inflation.

The Federal Reserve could try to lower interest rates by supplying money and credit more generously than it has. A faster growth rate for money would likely lower short-term interest rates temporarily, but only temporarily. Opening the money spigot further would add still more fuel to the fires of inflation. This in turn would add to inflationary expectations and interest rates would rise as lenders protect themselves by building in larger inflation premiums. So, a looser monetary policy aimed at lowering interest rates now would eventually lead to higher rates.

The surer way to lower interest rates is by reducing inflation. In order to do this, the Federal Reserve has to be less generous in supplying money and credit. Cutting back on the flow of money and credit into the economy itself will push up interest rates temporarily. In time, however, slower monetary growth will lead to less inflation and lower interest rates. So, a restrictive monetary policy now aimed at slowing the rate of inflation will lead in time to lower interest rates, not higher ones.

In the meantime, we should recognize that interest rates are playing an important role in combatting inflation. I say this despite the fact that the effect of interest rates has long been debated. I believe, however, that rising interest rates do choke off some demand for credit and therefore do help to bring total demand for goods and services into better balance with the

ability of the economy to meet these demands.

A final question remains, however: what is the impact of credit restraint and high interest rates on various sectors of our economy and society?

4) Evening Out the Burdens of Fighting Inflation

One of the burdens of combatting inflation will be a higher unemployment rate than we would like. I believe the benefits of moderating inflation will be widely distributed and therefore the burden of fighting inflation should be as widely distributed as possible. Liberalized unemployment benefits, public service jobs, welfare reform, training and education programs are all ways of dealing with problems of those hit hardest by slack in the job market.

The financial burdens of a restrictive monetary policy are also not distributed evenly across the economy. High interest rates, for example, impact heavily on housing and some public projects. A logical question, therefore, is whether we could allocate credit in such a way as to smooth out the burdens or even favor some high-priority sectors at the expense of lower-priority ones. In other words, should the Federal Reserve allocate credit as well as create credit?

I approach this question with considerable sympathy. Forces at work in our society, especially over the past decade, confront us with aspects of the distribution of burdens and benefits with an urgency that we have never felt before. They will not go away. There is good reason for the Fed to consider the matter of the allocation of credit with great care and concern.

A few years ago I explored the question as thoroughly as I knew how in a paper which I should be happy to submit for the record.* I asked our research staff to undertake further studies of selective credit controls, their

* "Federal Reserve Policy and Social Priorities," BUSINESS REVIEW, November 1970

history and their efficacy. The first volume of these studies will appear shortly after the turn of the year. I should like now simply to make five points in summary.

First, selective credit controls are less necessary when markets are working well. One reason credit does not flow into markets such as housing is that artificial limitations are placed on interest rates and lenders. The point is that action to eliminate usury ceilings and other such restraints would make selective credit controls less necessary.

Second, the Fed's experience in attempting to direct credit into "productive" and away from "nonproductive" uses has not been good. The reason is that it becomes virtually impossible in practice to determine which uses are really productive and which are nonproductive. I agree with those who believe that a basic solution to inflation is to enlarge the economy's ability to produce. My point is that selective credit controls offer little practical promise of directing funds in ways that will accomplish this. If, in fact, it should be part of policy to direct funds into capital investment, this is being done quite effectively by today's tight capital market.

Third, the idea that positive incentives might be helpful in directing funds in certain ways has a great deal of appeal. We in Philadelphia have done considerable analysis, for example, of the proposal that variable reserve requirements be placed on various kinds of bank assets. A lower requirement could be placed on high-priority loans and a higher requirement on lower-priority loans. Our research indicates a major problem: credit is extremely mobile and people are ingenious in substituting one kind of credit for another. If, for example, reserve requirements were to favor home mortgages over business loans, it seems inevitable that businessmen would simply bypass banks to go to other lenders or the open market. An effective program

of credit allocation would have to apply across the board. The workability of such a program seems questionable, to say the least. The costs could be enormous.

Fourth, if, in spite of these difficulties, Congress were to decide that credit should be controlled in accordance with certain social priorities, I believe that determination of these priorities is properly a matter for Congress, not the Federal Reserve.

Fifth, the goal of stimulating certain sectors of the economy and restraining others might in some cases better be approached through fiscal rather than credit action. The variable investment tax credit is one possibility. Direct provision of funds for the mortgage market is already being employed. Other possibilities should be explored.

I conclude from all this that, over time, the question of allocating credit should be studied further. Our analysis to date, however, suggests serious problems. Perhaps the most important point is that if we can avoid inflation through general monetary and fiscal policy, we have less reason to be concerned with the allocation of credit. A program of credit allocation is no substitute for responsible policy in dealing with the overall supply of money and credit.