

THE FED'S TOUGHER STAND AGAINST INFLATION

by

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If I had earlier any doubt about what to say this evening, that doubt was resolved last Saturday when the Fed announced a new package of measures to deal with the bad state of the economy. I would like to discuss this action in three parts: first, the reason for it; second, what it is; and third, what will result from it.

The background

Inflation has been getting worse, not better. We all see this in the supermarket and the gas station. Foreigners see it, too, and have been expressing their concern by marking down the dollar and buying gold.

I had expected that the rate of inflation would be coming down this fall as the economy slowed down, and that our international position would be improving. But inflation is staying stubbornly high and the dollar stays weak and gold prices seem to go up every day. The money supply is still growing too fast. Business is stronger now than I thought it would be.

Looking ahead, between now and the middle of next year, I see a mild recession. As spending slows down, pressure on prices should moderate, the money supply should stop growing so fast and our international position should improve. As this happens, people's expectations about the future of inflation may change and this in itself should help to slow inflation.

But none of this is certain and in the meantime action is needed to deal with both the fact of inflation and inflation psychology. The Fed's actions are intended to be this kind of a bridge.

The actions

The package consists of three parts.

First is an increase of one percent in the discount rate.

Second is a new marginal reserve requirement on "managed liabilities." The requirement is 8 percent on increases in these liabilities over a base date. The liabilities covered are large time deposits, Eurodollar borrowings, repurchase agreements against U. S. Governments and agencies, and federal funds borrowings from nonmember institutions. The main purpose of this new requirement is to slow down the growth of bank credit which is now proceeding at a very rapid rate. It is directed toward sources of funds that have played an important role in financing that expansion.

Third is a change in open market procedures. For many years the Open Market Committee has been operating on the basis that changes in the federal funds rate lead to changes in bank reserves which lead to changes in the money supply which influence economic activity and prices. These are the links in the chain--fed funds, reserves, money supply, the economy. For the last few years the Fed has been announcing targets for the money supply. It is difficult to hit these targets in the best of circumstances because there are many slippages between the links. Partly because of these slippages our success in meeting these targets had been less than spectacular.

But in addition to the slippages is a more fundamental difficulty. The Committee has not been willing to focus single mindedly on the money supply. It has modified its policies to some extent in order to achieve the level of interest rates it believed desirable. Now, many people have pointed out to us that it is impossible to have 100 percent success in getting both a desired money supply and a desired interest rate. The Committee, I can assure you, has been very much aware of this for a long time. The fact is, as I have said, the Committee simply was not convinced that either one should be the exclusive objective of policy. In any case, the price paid for this bi-focal view has been some misses in hitting our money supply target.

The change in procedure announced over the weekend will help us to hit our money supply targets, but the price will be wider fluctuations in interest rates in the money market. The Committee has studied this way of operating many times in the past ten years, so moving in this direction is not just a sudden whim. In executing the procedure the people managing the open market desk will have to feel their way to some extent, but the basic approach has been long understood and laid out. Essentially, a path for the reserve base will be plotted for the period until the next Committee meeting. This path is what appears needed to provide the reserves which will support the desired growth in the money supply. In the process, as supply and demand conditions in the money market vary from day to day the federal funds rate will move up and down much more freely than it has. So the links in the chain now are reserves-to money supply-to economic activity and prices, with movements in money market rates a by-product.

The results

Let me just try to answer some of the questions that are in your minds:

- Will the higher discount rate have any effect?

Of course, as banks come under more reserve pressure and feel the need to borrow from the Fed, they will have to pay 12 percent instead of 11 percent. This will have some effect in slowing down their lending. Also, the discount rate has long been a symbol of the Fed's intentions, and the increase of one percent tells the world that the Fed is serious about dealing with inflation. It is true that one percent increases will lose their psychological clout if we don't really succeed in slowing money growth.

- Where will the new marginal reserve requirement hit?

Mostly the large banks. These are the banks that use these types of managed liabilities and they are the banks that have the most money to lend right now. Smaller banks are feeling much tighter. In addition, the new requirements move into some areas that have been uncontrolled up to now and will help to meet the criticism of some people who say the Fed is too much concerned with the money supply and interest rates and not enough with bank credit.

- Will the new open market procedure really work?

I think so. This is potentially, and in the longer run, the most important of the three actions. Certainly the Open Market Committee has made a basic decision as between money supply and interest rates. It has taken a big move toward monetarism. This enhances the possibility of coming closer to our money supply targets. At the same time, although the basic procedures have been understood for a long time, they have not actually been practiced. So there is some risk involved and a certain amount of experimentation and trial-and-error will be likely for at least a while. And there are always the slippages in the chain which I described. So we will not hit bulls eyes, but should come closer than we have.

- Will federal funds rates be completely floating?

No. The Committee will watch the federal funds rate to see that fluctuations are not disastrously wide, but the intent is to let them occur within a broad range as supply and demand dictate. This will require some adjustment on the part of the

market, but I think that will be to the good. I have great faith that the money market has the necessary strength and resiliency to adapt.

- Will the new move raise interest rates?

Certainly in the near term. The fact that money growth is so strong suggests that higher rates will be needed for a time to get it slowed down. Most of the impact will be on short-term rates. Long-term rates should be more affected by longer-term prospects.

- Will the new actions hit the mortgage market?

As short-term rates rise, thrift institutions will find it still harder and more expensive to get the funds to make mortgage loans. So mortgage money should become tighter, and this should tend to reduce housing activity. The mortgage market should still fare better than in earlier tight money periods, however, because it is more protected from disintermediation.

- How long will interest rates keep going up?

I don't know. As I said at the beginning, I have been surprised by the strength of the economy and dismayed by the stubbornness of inflation. So interest rates have gone higher than I would have thought a month ago. But I still believe that the economy has a mild recession ahead of it and that we should be seeing less pressure on interest rates. Every day that passes brings us nearer to that time.

- Will the Fed's action bring on a severe recession?

It increases the chances of one. The Fed has been walking a narrow line, trying to slow inflation without precipitating a

severe recession. But inflation has not responded, the money supply has not responded and the dollar has not responded. Tougher measures obviously are needed, but the risks of sharper reaction on the downside obviously have become greater. We are walking a still narrower line. On the other hand, everyone in the Fed is convinced that if inflation is not gotten in hand, a disastrous recession will be the inevitable result.

- Will the actions work in slowing inflation?

They will help, but they need to be supported by responsible fiscal policy, a strong energy policy, cooperation at home by business and labor and abroad by foreign governments and central banks. I would be naive if I expected all these necessary things to happen, but I think enough of them will to bring the inflation rate down substantially from where it is now.

- But will inflation keep going down and stay down?

Not unless we all hang in there long enough to convince people that inflation is not a permanent way of life. This will take a considerable period of slow economic growth, a great deal of persistence by the Fed and much patience on the part of us all. There are no guarantees. But last Saturday's moves indicate that the Fed is determined to do its part.

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