

FED POLICY POST OCTOBER 6

Remarks by

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Marcus Nadler, who in his day made as many predictions as anybody, used to say that if you have to forecast, forecast frequently. The current pace of events confirms his advice. The way things have been going, anybody who forecasts is very likely to be wrong. The alternatives are either to shut up completely or to take your chances, with the understanding that you may have to come along with a correction soon after.

I'm going to elect the second route this evening, but before I make some comments about the near-term outlook I want to step back and take a broader view of the environment in which so many new and disturbing things are happening.

### Longer-view

As one who participates in making monetary policy, I've always found that the most fascinating, but most frustrating, part of the job is making tradeoffs among equally desirable objectives. It has been traditional to say, for example, that we want a policy that will keep the economy growing and fully employed and with stability in prices and the value of the dollar. It has become a truism that we can't accomplish all of these at the same time. We have to trade one off against another.

With all the problems the Fed faces today, we do confront one happy fact: a number of forces are moving in directions which reduce at least some of the severity of tradeoffs. What I have in mind is that three things are working together: one is inflation, a second is the role of the U.S. in the world economy, and a third is the public's swing to conservatism. Let me explain.

Inflation. Our country has had bad inflation in the past. If you look at a chart of prices going back to the Revolution you see something like a topographical map with numerous peaks and valleys. The peaks were in 1779, 1814, 1864 and 1920, all around wartime. After the wars, prices receded. At the end of World War II prices were about at the highs of the other wars. The difference is that they didn't come down. Had we followed earlier experience, prices should have dropped around the end of the 1940's. Instead, the price line shows almost a vertical lift. Moreover, the rise has been virtually continuous. Historically, prices moved in the same direction for no more than four or five years. Since 1945, prices have fallen in only five years, and since 1964 not at all, the longest unbroken record of inflation ever.

Why? The answer, of course, is complicated. But basically, it is that we as a society have tried to accomplish other things. We have tried to hold down unemployment, and on the whole have succeeded better than at any time in our history. We have tried to spread the "good life" to the disadvantaged and have established government programs to redistribute income. We have tried to correct abuses of the market economy by a network of regulations dealing with the environment, working conditions, financial transactions, etc. etc.

The result has been a burgeoning of government involvement, persistent Federal deficits, emphasis on consumption rather than saving and investment, a complex of subsidies and restrictions on various forms of economic activity. I'm not passing judgment. I'm simply trying to explain that we as a society have tried to do things other than hold prices down and, in doing these things, have encouraged prices to go up.

Well, this has now changed. The polls indicate that the public is more concerned about inflation than any other economic problem. So, for people making economic policy the job has become simpler. Support for a war against inflation has strengthened. Other objectives of economic policy have not disappeared but have receded in comparison with the need to get control of inflation.

Role of the U.S. in the world economy. While all this has been happening, the role of the U.S. in the world economy has diminished. After World War II, this country had such overwhelming economic power that the dollar was clearly the key currency. We assumed a great responsibility for the world economy, but at the same time, unlike other countries, could be fairly independent in our actions. Others had to fall in line. Then, almost overnight, began the dollar glut, deficits in our balance of payments, a declining share of world trade by almost one-half, and big drops in the value of the dollar against other major currencies. Finally, the crowning blow, came horrendous increases in the price of oil by a cartel over which we seem to be powerless. As our relative economic power has shrunk, we have had to behave more like other countries; we have been less able to go it alone. This means that compared with other nations we now have to watch such things as our inflation rate, our interest rate levels, our balance of payments, and the policies that influence them.

Again, our lives as policymakers become simpler. We now must do those kinds of things other countries have always had to do when their currencies were under fire. The most important of these is to restrain inflation. So the inflation problem and the dollar problem call for a common solution.

Swing to conservatism. Now comes the third development, which, of course, is closely related to the other two. This is the public's swing toward conservatism. Disillusioned with government controls, frustrated by persistent Federal deficits, embarrassed by the drop in the dollar, and--above all--alarmed by inflation, the public has begun to assert itself, and generally in a conservative direction. Politicians, alert to the changed mood of the electorate, are talking more about the evils of inflation, government spending, and living beyond our means.

For the Fed, of course, all this means that political sentiment is more likely to be in tune with what we think must be done to unwind inflation and stabilize the dollar in foreign exchange markets. The fact that the action taken by the Fed on October 6 has been so well received even by politicians who in other times reacted violently against "tight money" indicates the strength of the swing to conservatism.

So all three forces--inflation, the dollar, and the new conservative mood--all are working together to reinforce a strong monetary policy. This is a combination we don't often have and which the Fed is making the most of. How long this combination will last is something else, of course, and depends on how things go in the shorter-term--to which I turn now.

#### Shorter-term view

How will the Fed's October 6 measures work out? No one really knows, but let me make some guesses, starting with more immediate likelihoods and moving to more remote possibilities.

1. The market should settle down before too long to the new open market procedure. This procedure involves tracking bank reserves rather than the federal funds rate in order to hit our money supply targets. The

immediate reaction to the new procedure was bearish partly because everyone was uncertain about what it meant. Securities prices and money rates have gyrated as the market has groped its way. I believe that after a certain learning period markets should calm down, although money rates will still move more widely than they did under the old system.

2. The U.S. is likely to move into recession in this quarter of 1979 and continue in recession in the first half of 1980, recovering gradually in the second half. The difficult question is how severe the recession will be. Before October 6 I shared the consensus view that the recession would be rather mild and the pattern rather saucer-shaped. I still think this is the more likely scenario. But, clearly, whatever effect the October 6 action had was to risk a deeper recession. Mortgage markets and housing obviously will be more severely hit and this could spread to other parts of the economy. I would give the deeper-recession scenario somewhat less than a 50 percent probability. In any case, however, I don't expect anything as deep as 1974-75.

3. The inflation rate should start to recede in the months ahead. How much it will come down will be heavily influenced by what OPEC decides about oil prices at that time. Nobody knows. But inflation will be stubborn, and the Fed may find the going a good bit tougher with the economy softening and unemployment rising.

4. With a recession, and possibly a lower inflation rate, pressures on interest rates should ease. Whether rates are at their peak or still have some distance to go, when they will peak out, and how much they will come down are all questions I don't have the answers to and choose not to guess about. The important point is that present high rates will not be around forever.

5. As all this happens, a difficult problem for the Fed will be how rapidly to move to ease in view of the dollar's situation in foreign exchange markets. Theoretically, the new open market procedure could lead to a prompt and sharper drop in interest rates than the old procedure. That is, by controlling reserves, the Fed could see a natural decline in rates as the demand for credit falls off. But if the dollar is still in jeopardy, a sharp drop in interest rates could weaken it abroad. Not to let interest rates drop could exacerbate a recession at home. The Fed will have to monitor unfolding developments closely and not get boxed in by mechanistic procedures.

6. As the economy softens and unemployment rises, the national mood may change. Resolve to fight inflation may weaken, the current conservative trend may shift, and political pressures may lead to strong economic stimulation. If this happens, the fortunate combination of forces I spoke of earlier may disappear. The Fed will find less support for its inflation fight and more complicated cross currents to deal with. In that kind of environment the Fed's insulation against narrow political pressures--what is loosely called the Fed's "independence"--could become an invaluable national asset indeed.

7. Finally, whatever good effect may come from the Fed's action on October 6 in the long run will not amount to much by itself. It needs support from a strong energy policy, fiscal responsibility and restraint by labor and business.

In short, I feel optimistic that vigorous steps have been started. The short-term view will be looking better as markets adjust and interest rates peak out. But the longer view is full of problems and uncertainties which the Fed's action on October 6 only begins to deal with in a partial way. The Fed must continue to hang in there, but it needs a lot of company.