THE BATTLE AGAINST INFLATION:

IMPLICATIONS FOR FINANCIAL MARKETS

Remarks by

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One of the happier perquisites of my office is the location within my Federal Reserve District of everybody's two favorite cities--Honolulu and San Francisco. I'm very thankful for the opportunity to reside in one of these garden spots and now to visit the other. Yet despite the pleasant aspects of our meeting place today, the economy and the financial markets to which we must return are full of troubles. In the words of Lincoln, "The occasion is piled high with difficulties, but we must rise to meet these difficulties."

Many things have happened since I accepted your invitation, including the series of meetings which culminated in the National Summit Conference on the Economy just ten days ago. The final tally is not in yet, but a consensus of sorts has evolved from these meetings--principally that the new Public Enemy No. 1 is "stagflation," or the combination of inflation and recession. Nevertheless, I feel safe in saying that while there is much we must do to stave off recession, our main efforts must remain concentrated against the persistent problem of inflation.

Consensus of the Summit

The pieces of evidence which emerged from the Summit meetings give us a good picture of the problems we face and the context within which public policy must be forged. As I just indicated, inflation came into the meetings as Public Enemy No. 1, but some space on the

Post Office wall must now be allotted to another villain, recession. In this situation of stagflation, less price pressure is developing from the demand side, but more pressure is arising from the cost side as wage increases and commodity price increases chase each other upward. It is a harsh situation, in part because of the difficulty of overcoming cost-push inflation with the classical actions of monetary and fiscal policy.

Secondly, the energy problem has introduced a new and unprecedented constraint on the supply side. Again, there are limits to the degree to which monetary and fiscal policy can deal with such a situation. The battle against inflation must be joined with a concerted effort to save energy. We must face up to the fact that we have passed a watershed, from an era of cheap and extravagant use of energy into one of more expensive and more economical use of energy. The international conference of petroleum consumers held in Brussels two weeks ago should point the way to more international cooperation in this field.

Finally, a more vigorous use of fiscal policy is promised than had been expected prior to the Summit. President Ford stated that "we must adjust our tax system to encourage saving, stimulate productivity, discourage excessive debt and correct inflation-caused inequities." One possibility is tax relief for lower income families who have been most hurt by rising food prices. Another possible feature of the plan is exemption from taxation of the first $500-1,000 of savings interest in order to channel funds into home building. Business tax incentives have also been proposed to facilitate capital spending in the pursuit of greater productivity.

At the same time, President Ford is aiming for budget expenditures of $300 billion, which means a cut of more than $7 billion from existing appropriations. There has also been some talk of a surcharge on higher incomes to offset tax relief for low and middle-income families.

Budget Discipline

These developments highlight more than ever the necessity for Congress to bring the deficit-ridden Federal budget under control. The recently enacted budget-reform bill is a major step in the right direction, but there is much more work to do in this regard--and for that matter, the new budget-control procedures will not take full effect until the fiscal year which starts October 1, 1976. The intervening period will give Congress some time to put the new budgetmaking machinery in working order.

A recent public-opinion poll attributes most of the blame for inflation to government errors of commission and omission. It is difficult to quarrel with that conclusion. The Treasury has run deficits in 14 of the past 15 years, and as matters presently stand, will post another substantial deficit in fiscal 1975. These deficits have occurred with almost uninterrupted regularity, practically without regard to the stages of the business cycle. Over these 15 years, Federal expenditures have increased twice as fast as GNP.

The Federal Reserve has a vested interest in the Treasury's budget position because chronic budget deficits have led in the past to inappropriate monetary policy. The primary cause of inflation has been an inordinately rapid expansion of the money supply brought about by the financing of Treasury deficits. Generally, the script has gone this way: In the beginning, fiscal policy is excessively easy, and this generates budget deficits and increases the Treasury's demands upon the credit markets. The Federal Reserve tends to restrict the resultant rise in interest rates by supplying reserves. This easier monetary policy leads eventually to higher prices, so that monetary policy is forced to become increasingly restrictive to deal with the problem of inflation. In the face of continuing Treasury deficits, the alternative is the complete absence of restraint upon the forces that fuel inflation. The unhappy part of the problem is that the lack of budget discipline pulls monetary policy off course towards more ease than is desirable.

The large and continued Federal deficits of recent years have kept a steady upward pressure on interest rates. In the absence of new programs to control the budget, the deficit this fiscal year could exceed $12 billion. But suppose for a moment we were able to reduce this deficit by holding Federal spending to no more than $300 billion, as the President has proposed. Simulations with our Bank's econometric model indicate that, with tighter expenditures and a less restrictive monetary policy, short-term interest rates in fiscal 1975 could fall about 2 percentage points and long-term rates could decline by about 1/2 percentage point. It may be difficult to achieve significant reductions in Federal spending within such a short period of time, but the example illustrates the payoff to financial markets that could result from reduced Treasury spending and borrowing.

Public Policy Guides

Now, since we face the possibility of recession as well as the continuation of inflation, we ought to take a close look at the policy guides that we have used in the past, and in addition, examine other measures that might be used to ameliorate the problem of inflation and break some of the bottlenecks that have exacerbated our supply problems. By way of hindsight, some of our policy guides utilized in the past have not served us particularly well.

For the last dozen years one of the instruments used in formulating fiscal policy has been the concept known as the full-employment budget. Essentially, the full-employment budget represents the estimated budget position--either surplus or deficit--that the Treasury would face in any given year if the economy were in a state of full employment. The basic purpose of this measure is to determine whether current fiscal policy is appropriate to the existing economic situation. Generally, full employment has been defined in terms of an unemployment rate equal to 4 percent of the civilian labor force--a reasonable assumption a decade or so ago, but somewhat questionable today.

Unfortunately, it now takes a higher rate of inflation to achieve a 4-percent unemployment rate than it did a decade ago. This is due to two important factors. First, the changing structure of the labor force has brought higher participation rates for workers with marginal skills. Teenagers enter the labor force for the first time with a minimum of marketable skills and work experience, while adult women frequently re-enter the labor force with outmoded skills. The result is higher unemployment rates for these two groups of workers. These deficiencies are usually overcome with experience on the job, but they have been magnified over the past two decades as women and teenagers as a group have greatly increased their representation in the labor force relative to adult males. Then there is a second important consideration -- namely, that increased inflation expectations have caused labor to demand wage increases even at times when the unemployment rate is relatively high.

From this you can see the mischief that can be done by a full-employment budget which incorporates a 4-percent unemployment target. During much of last year, the actual jobless rate dropped only to 4.7 percent, despite peak levels of operations in the major materials-producing industries. If we had myopically followed the 4-percent unemployment target, we would have decided that the economy needed more stimulation. Thus, using a policy tool that is based upon an outmoded labor-market structure is an open invitation to inappropriate policymaking.

Primacy of Full Employment

In contrast, insufficient consideration has been given to equating the goal of price stability with the goal of full employment. There should be some change in the interpretation (if not the wording) of the Employment Act of 1946 to place equal stress on these two goals, since nowhere in the act is there a specific reference to fighting inflation.

Since the early 1960's, the goal of full employment has had clear precedence over price stability considerations. This is understandable within the context of that earlier period, for the jobless rate was then close to 6 percent while the rate of inflation was well below 2 percent. Full employment was defined essentially as 4-percent unemployment. This was as low as Arthur Okun--the father of the concept--thought that the unemployment rate could be pushed without putting undue pressure upon prices. But unfortunately, over the years the 4-percent unemployment goal has acquired increasing official and public acceptance. The sanction of time and precedent has turned it into one of the major sacred cows of the body politic.

The primacy of high employment over price stability as an economic-policy goal has impeded the monetary authorities in their attempts to deal with the problem of inflation. Much of our unemployment is structural in nature. Throwing money at it thus won't cure the problem, but will only serve to push up prices. No amount of monetary and fiscal ease can, by boosting aggregate demand, provide skills that are lacking or improve the imperfections of employment information or job mobility. These problems can only be handled through specific manpower programs which develop the necessary skills and work experiences as well as more complete information about job availability.

Mix of Policies

The most painful effects of a recession are always felt by those who have lost their jobs. Hence, several authorities have proposed ways of cushioning this type of loss. Chairman Burns, seconded by Mr. Simon, has proposed a program funded by the Federal government to provide necessary public employment at the state and local government level. Senator Javits has introduced a bill to enact just such a program, which would be funded up to $4 billion and provide as many as 600-800 thousand jobs. It would be triggered when unemployment reaches a specified rate and phased out when the rate subsequently declines. Incidentally, we've had some experience since 1971 with this approach, and the Administration recently has made funds available to provide 85,000 additional jobs of this type in the public sector.

One of the most widely repeated themes at the Summit conference was the need for government to stop interfering with the free functioning of markets. There are many laws and programs which were put on the books 40 or 50 years ago to remedy problems that have long since passed into history. To cite but one example, much of our agricultural legislation was written in the 1920's and 1930's when farming was in a severe and protracted depression. Many programs that made sense when surpluses of farm products impoverished the farmer, clearly make little sense today. To cite another example, railroad rates are set with scant regard for costs of shipping by truck or barge. And other transportation policies are equally questionable. For instance, it costs less to ship raw ore than it does to ship scrap metal--an ecologically as well as economically unsound procedure.

Other laws and regulations also affect costs or employment adversely through price- or wage-setting procedures. Most economists--both liberal and conservative--are opposed to present minimum-wage laws. These laws usually apply to jobs and trades which constitute the entry level of persons with minimal skills and work experience. Thus they affect teenagers and recent migrants from rural areas most heavily, by making it unprofitable for employers to hire such persons. If the minimum wage is to be retained, some form of differential ought to be introduced to allow unskilled persons to acquire apprentice-type work experience, after which they might then move on to the higher level of the minimum wage.

Other questionable legislation also helps to hold prices up. The Davis-Bacon Act requires the Federal government to pay prevailing union scales for construction work, thereby setting a floor under labor costs, and pushing up the price of new construction. The fair-trade laws, another development of the Depression era, permit producers to set a floor under their product prices. The "Buy American" clauses written into public contracts similarly act to fix prices, invariably above a competitively determined price. Whatever the original intent of these laws, they are now adding to our inflation problem.

The Economic Outlook

Turning now to the economic and financial prospects before us, I must confess that I've never seen a more uncertain period. The past year or so has presented us with a whole new ball game, and we are not yet familiar with the new rulebook. Despite all the discussion at the Summit, those agencies which are concerned with the labelling of business cycles have not yet decided that the present downturn displays all the characteristics of an official recession. But call it what you will, it is very definitely a slowdown of at least moderate severity, induced in large part by the supply constraints imposed by the oil embargo of last fall.

Real output this year will probably fall by more than one percent from the 1973 average. Of course, the largest part of the decline occurred in the first quarter, because of adjustments necessitated by the oil embargo. My economics staff is now expecting a sustained resumption of growth in real output in 1975, perhaps before midyear. However, the pace will be disappointingly slow, and the growth rate may not exceed 1 1/2 percent for the year as a whole. This rate is less than half of the typical growth of real output under conditions of full employment. With back-to-back years of such sluggish behavior, the increasing slack in the economy should ease price pressures.

Obviously we can use whatever help we can get, because prices continue to climb in an almost unrelenting progression. The consumer-price index for September will probably look very bad, since it will contain the sharp jump in the prices of 1975 model cars as well as some of the food price increases which have already shown up in the wholesale price index. However, here and there amidst the general gloom, there are occasional signs of price weakness, in commodities such as lumber, leather and copper. The demand pressures for internationally traded commodities are much less strong than they were a year ago, when most of the major industrial nations were all experiencing a simultaneous boom.

My economics staff forecasts that the inflation rate, as registered by the GNP price index, will approach or exceed 10 percent in 1974. This would translate into an increase of perhaps as much as 12 percent in the consumer-price index. With a period of sluggish growth expected in 1975, the inflation rate may decline moderately during the year.

Sluggish growth of course means higher unemployment, although we can hope that our recent good luck in this respect will continue. The rate today is only about 1 percent above the low point recorded last year, whereas normally we would expect roughly a 2-percent increase in such a situation. In part, this has been due to the fact that fewer people have been entering the labor force looking for jobs. However, my staff expects that the jobless rate will increase in coming months, perhaps approaching or even exceeding 6 1/2 percent next year. But in this case, a fully funded public employment program of the sort suggested by Chairman Burns could limit the rise in joblessness.

Inflation and Financial Markets

One of the unusual aspects of the current slowdown in the economy is the tendency for the financial-market effects to be much more severe than the effects on the real markets of employment, production and output. While the unemployment rate is lower than might have been expected at this stage of the business cycle, the financial markets are in much worse shape than we would normally expect. Both of these developments are related to the unprecedented inflation which is currently buffeting the national and the world scene.

In the labor market, the inflation has reduced real income for many households, but it has also reduced the real cost of labor to many firms, so that they have not cut back employment as severely as they normally would. In financial markets, the effect of inflation is rather more complex. The banking system plays a crucial role in the markets because of its unique ability to create money in response to the demands of the public for credit accommodation. The markets themselves play an intermediating role between savers and investors. New investments are financed by the issuance of securities and by the extension of bank loans. If savers and investors expect prices to rise over the life of their securities, they will demand an inflation premium in the interest rate to compensate them for the decline in the real purchasing power of their securities. I believe that this phenomenon is now well understood and recognized in the financial community.

During the period from 1966 to early 1973, the inflation rate gradually accelerated from under 2 percent to close to 5 percent, and this was gradually incorporated into higher interest rates in all sectors of the financial markets. However, in the last 18 months the rate of inflation has sharply accelerated into the two-digit range, creating a great deal of uncertainty in financial markets regarding what the appropriate inflation premium should be for securities in the future. The effect of this uncertainty is more severe on long-term financial markets than on short-term. The penalty for committing your funds at the wrong interest rate for ten years is much more severe than it is for three to six months. This goes a long way towards explaining why the long-term markets--bonds and equities--have been much more severely affected than the short-term markets for business loans and commercial paper in the past year. The banking industry has been one of the few sectors to exhibit any strength and viability during this difficult period, and it should be congratulated on its ability to handle the additional burdens thrust on it from other financial markets.

According to our staff forecast, the current distortions in financial markets will be gradually eased over the next year. In fact, short-term rates are already receding from their high levels of several months ago. Short-term rates should fall more rapidly than long-term rates, which may move down very little from their present levels. On the basis of recent experience, long-term rates could be more sticky on the down side than short rates, since inflationary expectations are built more solidly into long-term rates, and since we may encounter a relatively modest diminution of the rate of price inflation next year.

Another important consideration, much discussed by the avid breed of Fed watchers, is the central bank's determination not to overdo its necessary posture of monetary restraint. The Federal funds rate, considered by many as a bellwether of Federal Reserve policy, has declined in recent weeks. Marginal reserve requirements against certificates of deposit of longer maturities were dropped several weeks ago. But again, in view of the severity of the inflation, we should not move too aggressively toward ease in coming months.

Contingency for Crisis

In this connection, I've been asked many questions in recent months about the soundness of our banking system. Whenever I replied that I saw no cause for alarm, I received some very skeptical looks. So, let me use this forum to state most emphatically that I see no danger of a major financial collapse or liquidity crisis. Some large banks here and in Europe have gotten into trouble, but these problems have arisen from the management practices of specific banks rather than from the structural weakness of the entire banking system. To the classic formula for bank failure--fraud, frequently related to the pursuit of slow horses and fast women--we may now add a new dimension--speculating in foreign currencies, which has an enormous downside risk in an era of floating exchange rates.

In a banking system with well over 14,000 banks, it should be expected that some institutions would become overextended and experience larger-than-average loan losses. These banks show up on the FDIC's problem-bank list, which now includes about 150 banks--actually, somewhat fewer than two years ago. In any event, the regulatory agencies are maintaining a close watch on possible problem situations to ensure that any difficulties are corrected as they arise.

What is the Fed's part in all of this? One of the fundamental duties of a central bank is to act as lender of last resort to banks that are solvent but are faced with a severe liquidity problem--usually a heavy runoff of deposits. The resources of the Federal Reserve are enormous if not limitless, and are entirely adequate to handle any foreseeable situation. The Fed is fully prepared to assist sound banks and, if necessary, to lend on an emergency basis to nonbank financial institutions.

You financial managers must frequently be reminded these days of Thomas Paine's well-known phrase, "These are the times that try men's souls." The pressure on short-term credit markets has resulted in a steeply negative-sloping yield curve. Even though short-term rates are currently higher than long-term rates, a case may be made for borrowing short for months rather than being locked in for years at today's long-term rate. But this course of action is not without risks of its own. It seems essential that corporations achieve as good a balance as possible between their sources and uses of funds. Excessive reliance upon short-term credit should be discouraged. In particular, borrowing short to finance capital expenditures can distort cash flows and leave the firm uncovered to undue risk.

The prudent use of funds has always been the hallmark of a successful banker. But today, faced with an insatiable demand from all quarters for a finite amount of funds, bankers must ration whatever is available in an effort to increase output without placing undue pressure on prices or interest rates. The Federal Advisory Council--a committee of twelve leading bankers representing each of the Federal Reserve Districts--has formulated some guidelines for bank lending policies, and these guidelines have recently been endorsed by the Board of Governors. The Council foresees a lengthy period during which the supply of funds will be limited. Thus, it argues, banks should restrict the growth of their loan portfolios and screen most carefully the uses to which they will put their loanable funds, giving priority to the basic needs of established customers and of those new customers planning productivity-enhancing investments. Also, banks should give consideration to the special vulnerability of the homebuilding industry. Consumer loans for household goods and automobiles should be accommodated, but deferrable spending should not be encouraged. Finally, loans to foreigners from domestic sources should be scrutinized carefully, and loans for acquisitions or speculative purposes should be discouraged.

Concluding Remarks

It is always desirable to end a speech on a high note, indicating that the road ahead of us is smooth and bathed in sunshine. Unfortunately, a peroration of that type would be grossly misleading in today's economic climate. The year ahead will probably be disappointing in terms of economic growth. The unemployment rate will most likely increase. Although the rate of inflation should decline, it may be by a disappointingly small amount. Indeed, we may be well into 1976 before we see a substantial improvement in the fight against inflation. But the outlook can be made brighter for interest rates if Congress succeeds in pushing the Federal budget into balance, or better, into a modest surplus. This would impact most favorably on the short-term market, marked as it has been by severe disintermediation and other problems.

And what of monetary policy? The worst mistake that could be made would be to adopt a policy of aggressive ease in order to stimulate the economy. Most of this year has been required to get the rate of growth of the money supply down within reasonable bounds. To sacrifice these hard-won gains would be a grievous mistake. From where I stand, an appropriate monetary policy for 1975 would be less severe than it was this summer, but still well short of the aggressive ease of several years back. One hundred years ago, Walter Bagehot laid down the dictum that "money will not manage itself," and this is still true today.

Finally, in the aftermath of the somber Summit Conference, we are realizing that there are no easy answers to the difficult questions which confront us. Some useful legislation may develop out of the Summit deliberations. In addition, improved policymaking machinery may develop out of the new economic policy board, the labor-management council, and the wage-price monitoring agency. But the major lesson of the Summit is epitomized in the President's comment, "Nations which cannot impose upon themselves a disciplined management of their fiscal and monetary affairs are doomed to economic disorder and widespread inflation."

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