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Monetary Policy Developments

Remarks of

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It's always a pleasure to swap shop talk with members of the NABE. Business economists are always on the firing line--in more ways than one--dealing with constant pressures to apply the elegant formulations of academia to the hard and dirty numbers of the real world. In that respect I'm sure you can sympathize with Federal Reserve policymakers, who have the task today of reconciling conflicting theories, conflicting policy goals and conflicting data in providing the monetary contribution to a strong yet noninflationary recovery.

When Alan Carl asked me to appear today, he suggested that the title of my talk might be, "Will the Fed Abort Recovery?" That could make for a very short speech, because I would be tempted to rise, answer "No," and then sit down again. If instead I wanted to discuss all the complications involved in our present economic and financial plight, the speech could go on for hours. All I can do is compromise and discuss, in fairly broad-brush fashion, some of the major factors influencing monetary policy in this present recovery period.

Development of Policy

Let me begin by describing how monetary policy is developed, beginning with the role of a regional Federal Reserve Bank in the formulation of policy. We participate primarily through our work with that key decision-making body, the Federal Open Market Committee. I attend all of the monthly meetings of the FOMC in Washington, and attempt to make a contribution through an analysis of the issues as presented by my own research staff as well as the Board of Governors' staff. I make sure that our research staff includes economists with a wide range of backgrounds--and I also make sure

to get inputs not just from economists but from as wide a circle of informed opinion as possible. This is where a good Board of Directors is most helpful.

All Federal Reserve Banks (and branches) have directors representing regional business, financial and public-interest groups. These boards exercise certain management powers, but in addition, they are immensely valuable to me as sources of economic information regarding the fields in which they operate. Some observers question the quality of this "grass-roots" information; that eminent agricultural economist, John Kenneth Galbraith, did so explicitly in his recent best-seller, entitled "Money." But I disagree; no matter how strong our theory nor how solid our data, there is no substitute for the feel of the marketplace to tell us if policy is having its intended effect.

Now in developing his view of the correct course of policy, each FOMC member has in mind some basic economic forecast, along with a notion of the range of uncertainty around his own projections. These estimates regarding the economy's most likely course are compared by each FOMC member to his view of the economy's most desirable course. Appropriate monetary policy consists of selecting certain targets, affecting the expansion of monetary aggregates and associated money-market conditions, which minimize the difference between the most likely and the most desirable course for the economy in terms of prices, output and employment.

After debating the issues surrounding the economic forecast, the FOMC decides on its basic monetary-policy stance--a stance which in recent years has been specified largely but not entirely in terms of targeted growth in the monetary aggregates. Committee members understand the many uncertainties

surrounding the outlook and the effects of policy, and they are well aware that policy actions affect the economy with a lag, so that they set the money-growth targets in a forward-looking way rather than simply in response to the current business situation. The long-run targets for the twelve-month period ahead are now reported quarterly, alternately at meetings of the Senate and House banking committees.

Factors Affecting the Recovery

Now let's consider the environment in which monetary policy is operating. We begin with the realization that the recession was over almost six months ago. Unfortunately, whenever an economist makes that point, he's denounced as a heartless wretch, whereas he's only stating an obvious statistical fact. Certainly it's true that almost one-third of the theoretical capacity of the nation's industrial plant remains unutilized, and certainly it's true that roughly one-twelfth of the labor force remains unemployed. Nonetheless, the major aggregates of production and employment have risen substantially in recent months, to mark indisputably the beginning of the recovery. Indeed, as Geoffrey Moore tirelessly points out, the percentage of the population actually employed during this "worst postwar recession" is somewhat higher than in most earlier recessions, and is actually near record levels for both adult women and teenagers.

The recovery script was written during the spring months, when consumer spending rose at more than a 6-percent annual rate (in real terms), reflecting an unparalleled 22-percent rate of gain in real disposable income. Take-home pay was boosted by the front-loading of the $23-billion Tax Reduction Act, which included not only the tax reductions but also some increases in social-security and other transfer payments. That stimulus

was reinforced by a slowing of the inflation rate. At present income levels, where a one-percentage-point drop in the inflation rate means an $11-billion boost to real disposable income, we obtain roughly the same income boost from a two-percentage-point drop in inflation as we got from the tax-cut bill. The strong consumer showing was repeated in the third quarter, when real spending rose at almost a 7-percent rate on the basis of an upsurge in the durable-goods market.

The second major element in the recovery script is the improving situation in inventories. Business inventories declined at a $25-billion annual rate in the first half of this year--and at almost half that pace in the third quarter--so that stockroom shelves have now been cleared of most of their excess supplies. Just ending the cutbacks, without any net increase in inventories, would thus remove a substantial depressant on GNP. Another important factor is our continuing strong foreign-trade balance; remember, the nation's exports have doubled within the last three years, contributing to a shift in the trade balance from a $6-billion deficit in 1972 to a $12-billion rate of surplus to date in 1975. Moreover, the housing industry, for all its structural problems, has improved substantially since last winter's lows. For all these reasons, I can see some validity to Allan Greenspan's easy-to-remember forecast of three 7's for 1976--that is, real growth of 7 percent, inflation rate of 7 percent, and unemployment rate of 7 percent, either on a year-end or yearly average basis.

The general expectation, then, is that the bicentennial year will be a considerable improvement over what we've experienced recently, but will still contain some elements that are unacceptable on a long-term basis. Now that an adequate growth rate is being achieved, we must concentrate

our efforts on reducing both unemployment and inflation. On the job front, a number of approaches may be considered--greater investment in plant and equipment, the removal of private and governmental restrictions on job and product markets, and in addition, expansion of public-service employment in an attempt to get people onto the job rolls and off the welfare rolls. The problem of inflation appears equally complex, but it has been compounded by the impact of soaring Federal deficits on private markets and public policy.

Federal Deficits and "Crowding Out"

The nation was 186 years old before it first recorded a $100-billion budget. It took nine years to exceed $200 billion, four years to exceed $300 billion, and probably only two years more to exceed $400 billion in Federal spending. Earlier increases reflected the costs of past and future wars (including interest on the rising debt), but the recent explosion has largely reflected the vast expansion of health-education-welfare programs. To a great extent, this phenomenon represents the federalization of many functions that were formerly handled by families, private agencies, and state and local governments. The basic difficulty of course has been the failure of Federal budget-makers to find the funds to pay for these growing responsibilities, and it has been aggravated by the impact of inflation on the growing number of indexed programs. The problem threatens to swamp the new Congressional budget committees at the very inception of their activities, but it is one which they must grasp and bring under control.

More Federal spending would aggravate the pressures already evident in financial markets, with unparalleled Federal demands piled on top of gradually reviving private credit demands. This is the well-publicized and all-too-

real problem of "crowding out." It's true that financial conditions normally ease substantially during a recession and remain easy even in the initial recovery period. But if the Federal deficit substantially exceeds the House Budget Committee's $72-billion target, total credit demands could rapidly outrun the available supply of funds, forcing interest rates higher and crowding many non-Federal borrowers out of the market. We've already seen interest rates turning up, when typically they continue falling during the early recovery period. Certainly it's very unusual at this stage of the cycle to see Treasury bill rates hovering near 6 percent, or the prime business-loan rate close to 8 percent.

Many analysts believe that the "crowding out" argument is overdone, and that we are more likely to encounter a "crowding in" effect as the economy continues along its recovery path. According to this view, as long as deficit spending succeeds in its goal of stimulating business activity, the growth in profits will lead to more capital investment without any significant increase in pressure on financial markets. Admittedly, the profits picture has improved in the last two quarters, and a continued improvement can be expected as business sales increase. But we have some distance to go to achieve the average return on capital considered normal a decade ago, and meanwhile the nation's investment needs grow apace--for energy development, for pollution control, and for job creation in general. It's only logical to expect a substantial growth in private credit demands in these circumstances, which means wholesale crowding out if Treasury deficits fail to contract as the economy recovers.

Monetary Policy Role

One way that mounting credit demands can be satisfied without an increase in interest rates is for the Federal Reserve to accelerate the growth of money and credit. But if done for too long, or to an excessive degree, such an action could generate inflationary pressures which would soon become imbedded in our ratchet-like price structure. Still, many people reply, with so many idle resources in the economy, how could inflationary pressures arise from easy money at this stage?

The answer, at least in part, involves the lags in the effects of monetary policy, which seem to be much shorter for production, employment and profits than for prices. Of course, it's altogether appropriate to follow a countercyclical stabilization policy. Even so, it's reasonably clear that when an excessively easy-money policy is adopted, the "good news" appears first, with production, employment and profits expanding within six to twelve months or so--but then the "bad news" arrives, in the form of increased inflation with a lag of one to three years. Conversely, if a tight-money policy is adopted, the bad news of a dampening of economic activity comes first, whereas the good news of a diminished rate of inflation is delayed. This is the type of consideration that the Open Market Committee must continually keep in mind.

At this stage of the cycle, Fed policymakers have to be alert to price developments, but equally alert to the need to provide the financial basis for continued recovery. In a word, we must maintain a prudent but not parsimonious monetary policy. This stance is seen in the monetary growth paths specified by the FOMC between the second quarter of 1975 and the second quarter of 1976--the well-publicized 5-to-7½ percent growth rate for M_1, and

the less-publicized range of 8½-10½ percent for the broader M_2. The mid-points of those ranges are roughly in line with the average growth rates actually experienced over the past half-decade.

These ranges are quite appropriate in the present environment of high unemployment and unused industrial capacity. On the other hand, they are on the generous side by long-term historical standards. Thus, we could endanger the fight against inflation if we continued expanding the money stock indefinitely at today's specified pace. As the economy returns to higher rates of resource utilization, we'll have to reduce the rate of monetary and credit expansion, in order to lay the foundation for a prolonged era of prosperity without inflation.

Concluding Remarks

I hope that, from my remarks, you've gotten some feel for how we've arrived at our present monetary posture. I've reviewed the development of monetary policy, to indicate the scope of its impact upon the economy. I've noted the strength of those forces which have generated and sustained the business upturn, but also highlighted those counterforces which could yet undermine the recovery. In particular, I've suggested the way in which an outsized Federal deficit could endanger the upturn, either by draining funds from the financial markets that are needed by private borrowers, or by forcing a shift to an open-handed monetary policy that could set off another double-digit inflation.

All of this underlines the rationale for a moderate policy of monetary expansion--an argument which was stated succinctly by Paul McCracken in an article in the Wall Street Journal early this year. "The goods and services available for money to command are always short of what in the aggregate

people would like to have (which is why the discipline of economics exists). It follows, therefore, that the 'right' amount of money will always seem to be not enough, and a serious effort to provide 'enough' would lead to inflation." Following up McCracken's thought, it's evident that many credit demands will be difficult to meet in the period ahead, especially in view of the heavy capital requirements of American industry with which we're all familiar. But to the question asked at the outset, "Will the Fed Abort Recovery?" the answer is still "No."

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