

INFLATION, UNEMPLOYMENT AND STABILIZATION POLICY

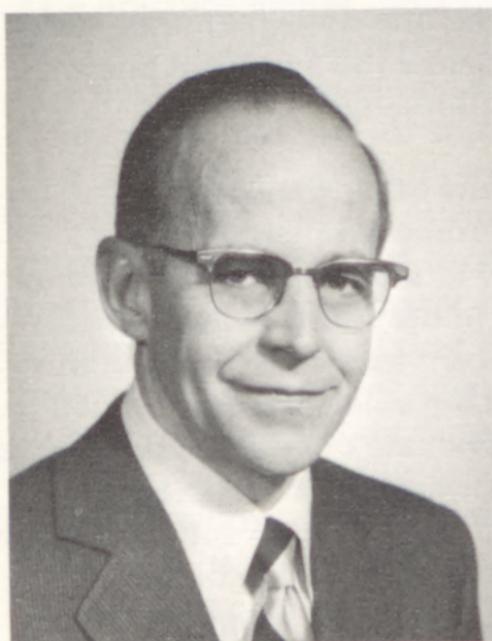
REMARKS BY

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It is a pleasure to be with you this morning on the program of the California Bankers Association. I only hope you won't think I'm trying to spoil your stay in San Francisco by discussing economic problems with you. But as a former commercial banker I think I share many of the same concerns as you, and now, as a central banker, I may perhaps be forgiven for sharing with you some of my more recent concerns. As it turns out, these problems have a very direct bearing on the economic climate within which commercial banks must operate.

The nation today faces severe inflationary problems, almost without precedent in a peacetime economy. Certainly, we are seeing rates of inflation that virtually no one would have anticipated a year or so ago.

If they had, given the normal expectation of the way that prices and unemployment rates interact, they probably would have guessed that the unemployment rate today would be far below the 5 percent rate that we are now witnessing.

More than at any other time in recent history, the current inflation has been strong enough to mobilize the citizenry to lobby actively in the cause of lower prices—witness the recent meat boycott. And businessmen and consumers have had much to lobby about. The rate of inflation jumped to a 6.6 percent annual rate during the first quarter of 1973. That sudden spurt was even worse than the price upsurge of late 1970 and early 1971, which led eventually to the imposition of the price freeze. In addition, the performance of consumer prices in April could be called moderate only in comparison with the headlong pace of the several preceding months, while wholesale industrial prices rose more rapidly in April than at any other time since the panic-buying days of the Korean War period.

The inflation problem is serious indeed, and in my comments today I would like to suggest some of the key factors that brought us to our present pass. Among other things, I will have something to say about the need for stabilization policy which blends together monetary and fiscal inputs, so that the excesses of both recession and inflationary boom are kept within check.

The active use of stabilization policy to achieve these effects can be dated back at least a quarter of a century. By way of illustration, the Congressional Subcommittee on Monetary, Credit and Fiscal Policies recommended in 1950 the use of economic policies which would achieve the

goals of the Employment Act of 1946—namely, to promote maximum employment, production and purchasing power. As a practical matter, policymakers during the 1960's stated employment goals in terms of a desired minimum unemployment rate. A 4-percent rate was for some time thought to be attainable, without serious inflationary consequences, mainly through appropriate monetary and fiscal policies. Put another way, it was widely accepted that an unemployment rate higher than 4 percent implied a deficiency of aggregate demand, to be remedied mainly through fiscal and monetary stimulus. This may well be the wrong diagnosis and the wrong medicine. Now there is good reason to believe that the conventional unemployment rate has been a poor signal for stabilization policy in recent years. The evidence now suggests that to get the conventional unemployment rate down to 4 percent by relying mainly on broad measures affecting aggregate demand will result in an unacceptable rate of inflation—politically, socially, and economically. If so, other policy measures will have to be used more actively to achieve the desired goal of an unemployment rate not exceeding 4 percent.

The Unemployment-Inflation Trade-off

Behind the mix of monetary and fiscal influences in the national economy lies the notion that unemployment and inflation are inversely related. At least since 1958, when A. W. Phillips' seminal article appeared in the British journal *Economica*, the attention of economists has been focussed on the inverse relationship between the rate of change of money wages and the unemployment rate. Most economists have assumed that a lower unemployment rate implies a higher rate of inflation in the short run. In other words, they have assumed that a trade-off exists between unemployment

and inflation. The nature of this trade-off is subject to some controversy, but it is essential that policymakers be aware of the existence of a trade-off and how it behaves over time.

The trade-off between inflation and unemployment becomes critical during periods of rapid growth. Indeed, in recent months, as the nation emerged from a period of strict wage and price controls, many economists assumed that the trade-off was the same as that which prevailed prior to August 1971. The assumption is not good enough. More attention must be given to the composition of the unemployed, as well as to the effects that fiscal and monetary policy have on prices at given rates of unemployment.

The unemployment rate among young people has severely increased in the last dozen years or so. For example, the jobless rate for 16-19-year-old males was 3½ times the rate for 25-64-year-old males in 1955, but by 1970 the teenager rate was 5½ times larger than the rate for the older workers. The picture for young women has been even worse. The unemployment rate for male heads of household, 16-24 years old, dropped last year, but the comparable rate for women increased.

In addition, although we have made important strides in improving the employment opportunities for nonwhites, significant employment differentials on the basis of race still exist. We have only to look at the Labor Department's **Employment and Earnings** statistics or the **Economic Report of the President** to see that the unemployment rate for blacks and other races in 1972 was twice the unemployment rate for whites.

Structural Unemployment

The distinction between different types of unemployment, which many of us relied on in years past, is of limited use in analyzing the current trade-off between unemployment and inflation. Indeed, I believe that much of the current unemployment can be termed "structural," in the sense that it is due to the age, sex, racial or geographic makeup of the potential labor force, and not simply due to cyclical or seasonal relationships between job vacancies and demands for employment. Evidence of persistent geographic differentials in unemployment, for example, shows that cities with high-wage rates may also tend to have high unemployment rates.

Two factors which are expected to equilibrate labor supply and demand, the mobility of the labor force and the mobility of employers, do not seem to work well in many urban areas. If prevailing wages are higher in some urban centers, such as San Francisco and Los Angeles, than they are in competing areas, workers may refuse the work available in the lower-wage areas, and help to increase the average duration of unemployment in high wage areas. Available data, in fact, indicate that the average duration of unemployment is positively correlated with the average wage rate in a dozen U.S. cities.

Recent studies also suggest that, at or near full utilization of resources, many of the unemployed do not have jobs because they lack upward mobility in the labor force. These individuals may move from one low-paying job to another, with long periods of joblessness in between. For example, black males in low-wage employment have significantly longer periods of unemployment than white males in the same low-wage category.

Because of these structural problems, we may well find that the aggregate unemployment rate during, or near, periods of full utilization of resources, cannot be significantly reduced by monetary and fiscal policies which operate through their influence on aggregate demand. In pursuing a policy aimed at reducing unemployment, expansionary fiscal and monetary policies have had their primary impact on the general price level. In other words, labor markets in recent years have been tighter than the general unemployment rate suggests on the basis of experience in the 1950's or early 1960's.

A Better Measure

The concept of a "weighted unemployment rate" is a step in the right direction in indicating current pressures on labor markets. To construct a weighted rate of this type, the unemployed in each age-sex group are weighted by an index of the wages and hours of work common to this age-sex group. The theory behind this index recognizes that all workers are not exact substitutes for each other in the labor market, and that serious labor shortages can occur in different industries at different times without an overall shortage of job seekers. The index is an attempt to quantify and weigh shortages in specific categories of labor, so that we can define labor-market tightness in a more meaningful way.

Studies by the Brookings Institution using weighted unemployment indices suggest that the conventional unemployment rate has been a very misleading indicator of labor-market tightness since 1965. For example, 40 percent of the unemployed during the mid-1950's were males in the (25-64 years old) prime age group, while at the end of the 1960's prime age males consti-

tuted only 23 percent of the unemployed. The weighted unemployment index was 2.5 percent in 1969, instead of the official 3.5 percent, and 3.8 percent in 1970, instead of the official 4.9 percent. If current data were available, they would probably show a similar picture.

The problem with an indicator like the conventional unemployment rate is that it can mislead us into believing that the trade-off between inflation and unemployment is lower than it really is; in other words, that a given rate of unemployment is associated with a far lower rate of inflation than in fact is the case. It appears to me that this has been a major problem in the last year or so.

There also is a problem in comparing unemployment rates over time, because the set of trade-offs between inflation and unemployment may change significantly. George Perry of the Brookings Institution has found that in the late 1960's a 4-percent unemployment rate was associated with a 4.4-percent annual rate of inflation, whereas in the mid-1950's a 4-percent unemployment rate was associated with a 2.9-percent inflation rate. These findings suggest that both monetary and fiscal authorities must use greater caution in exercising their influence on monetary and expenditure aggregates. The use of monetary and fiscal policy instruments, as presently constituted, to achieve a 4-percent unemployment rate, as conventionally measured, may prolong an unsustainable rate of growth in output and further aggravate inflationary pressures. This underlines the need for a new approach to the problem, as I mentioned earlier.

The forces which might be expected to alleviate unemployment are not as effective as many observers believed. A 4-percent

unemployment rate in 1956 is not the same as a similar rate in the mid-1970's, because it involves different categories of jobless people. The large population of unemployed young people today is certainly cause for serious concern and social action. But these unemployed are unlikely to be drawn into the ranks of job-holders solely, or even mainly, by increasing the overall level of economic activity.

Structural unemployment cannot be solved with general expansionary policies. It can only be solved with specific programs designed to place people in jobs for which there is a demand today. Using weighted unemployment rates, we can measure the tightness of labor markets, and we know in what segments of the labor force unemployment hits hardest. What Congress must now do is to redesign the tools that we use to combat unemployment. It must put more emphasis on manpower training, on measures to facilitate job mobility, and the like, similar to the measures introduced to assist jobless scientists and engineers during the aerospace recession several years ago. Federal expenditures could be aimed at specific pockets of unemployed, once these pockets are determined to be excessive.

Cost of Expansive Policy

Various critics hold the view that, in the last few years, policymakers have misinterpreted unemployment statistics and underestimated the impact of expansionary monetary and fiscal policy on the general price level. Specifically, they believe that Congress and the Administration were overly optimistic in assessing the potential of wage-price controls to contain inflation in the face of very large Federal deficits, and that the Federal Reserve did not take sufficiently into account the lags in the impact of monetary policy on the economy.

Hence, they conclude that an expansionary policy was pursued for too long a time. During 1972, the U.S. economy still had substantial idle capacity and substantial unemployment; the conventional jobless rate was as high as 5½ percent as late as last October. Policy was therefore directed toward solving those immediate problems. Unfortunately, almost all forecasters underestimated the speed with which shortages developed in required labor skills and with which full-capacity operations developed throughout industry.

One cost of expansionary policy in 1972's environment of controlled wages and prices is that it may have led the public to believe that controls are a good substitute for aggressive anti-inflationary monetary and fiscal policy. In my view, nothing could be further from the truth. The market place is the most efficient allocative device we have, and when combined with aggressive counter-cyclical economic policies, will always win out over a system of controls. While controls may be instituted to correct distortions arising in the market economy, we should not lose sight of the efficiency which results from the interaction of supply and demand forces with appropriate economic policies to control aggregate demand.

Recent Monetary Policy

I would be remiss if I did not mention to an audience of bankers the Federal Reserve's actions since the first of the year to impose monetary restraint. During the first four months of 1973, the money supply—defined as adjusted demand deposits and currency in circulation—grew at only a 3.3-percent annual rate, in contrast to the 8.5-percent annual growth rate in the second half of 1972. This result flowed from a conscious change in Federal Reserve open-

market policy. Further, the discount rate was raised in several steps between January and May, from 4½ to 6 percent. Generally, these moves were made in an effort to slow down the rate of monetary and credit growth, with a view to combatting today's severe inflationary pressures. More recently, the Federal Reserve has placed marginal reserve requirements on negotiable certificates of deposit, finance bills and bank-related commercial paper, with a view to dampening the excessive expansion of bank credit, especially to business. At the same time, interest-rate ceilings on CD's of 90 days and over have been suspended and reserve requirements on Eurodollar borrowings, in excess of the reserve-free base, have been reduced from 20 to 8 percent.

While on the subject of marginal reserve requirements, I would like to make a few comments about Chairman Burns' request to some 190 large nonmember banks to voluntarily comply with the new marginal reserve requirements imposed upon member banks. This request included a provision that any such reserves held by nonmember banks be deposited with a member bank, which would then redeposit these balances with the Federal Reserve. The purpose of this redeposit proposal was not to attack the existence of the dual banking system, as has been the belief in some quarters.

The redeposit proposal is based on an important technical point: namely, that unless the new marginal reserves held by nonmember banks with their correspondent member banks are redeposited with a Federal Reserve Bank, these reserves will not be sterilized. Instead, they would be available for credit expansion, and all that would have occurred would have been a shift of lending capacity from nonmember

banks to member banks. It was on this basis that the request was made for redeposit of such voluntarily-held marginal reserves with the Federal Reserve System.

I would also like to urge your cooperation with Chairman Burns' May 22nd request to all member banks, to see that the rate of bank-credit extension is properly disciplined. The boom now going on in the economy, especially in the capital-goods area, is adding substantially to inflationary pressures. Therefore, some sense of restraint by the banking industry in financing this capital-goods boom would make an important contribution to our joint anti-inflationary effort.

Having commented on the recent actions taken by the Federal Reserve to combat our severe inflationary problem, I would also like to indicate the practical limits on the use of monetary policy for this purpose. We have seen in recent months the strong resistance that can arise in Congress to the high levels of interest rates that are an inevitable accompaniment to a period of credit restraint. In earlier periods, we have seen also the uneven impacts on different sectors of the economy that have developed during periods of credit restraint. With limitations such as these, the use of monetary policy can sometimes be a difficult exercise.

I would be the last to claim that the execution of monetary policy has been error-free, in terms of judgments on magnitude and timing. Having said that, however, I think it is fair to recognize that monetary policy cannot carry the entire burden of the anti-inflationary program. It would be inequitable and undesirable in terms of its economic effects to have it do so. Thus, I think we should be deeply concerned

about the lack of vigorous use of fiscal tools to combat inflation. Despite the commendable efforts of the Administration to hold down the level of Federal expenditures, we are still confronted with a Federal budget deficit officially estimated at about \$18 billion for the current fiscal year. And this at a time when inflation has reached a clearly unacceptable rate. In the view of any reasonable observer, this must surely constitute a great imbalance in the use of monetary and fiscal policy.

Unless or until some device is adopted to eliminate budget deficits and preferably produce budget surpluses in periods of boom and inflation, we will continue to be faced with this problem. There have been many proposals over the years to remedy the situation, ranging from discretionary authority delegated by the Congress to the President to change income tax rates or the investment tax credit, within certain limits, to "automatic" tax surcharges to be triggered by a certain rise in the price level. But unfortunately, none have been adopted. In my view, the time has arrived when the country can no longer afford not to do so.

Summary and Conclusions

Based on the current evidence of an unsustainable pace of economic growth and a rate of inflation which is a dangerous threat to economic stability, it appears to many observers that aggregate expansionary policies have been used too vigorously in the last several years, in an unsuccessful attempt to achieve a substantially lower rate of unemployment than the present 5 percent, as conventionally measured. Monetary and fiscal stimulus has not succeeded in dealing with structural unemployment, which needs to be attacked by other means.

A good part of the excessive expansionary

stimulus has been due to the problem of measuring the trade-off between inflation and unemployment. Our price statistics are generally reliable, but our conventional indicator of unemployment has been unsatisfactory, creating a serious problem for policymakers. Economic analysts must devote more attention to this problem, in an attempt to develop better measures of labor-market conditions and a more meaningful unemployment rate.

Meanwhile, it is urgent that selective tools be developed and used more actively to bring the unemployment rate down to an acceptable level, within the framework of reasonable price stability and healthy but sustainable economic growth. Since much of today's unemployment is structural, in my judgment, it can best be solved with such specific measures as better manpower training and efforts to increase job mobility.

At the same time, in confronting inflation we have shown a chronic inability to dampen Federal expenditures sufficiently and to increase taxes when required. The task of solving this problem lies with the Administration and Congress. While harping on the size of fiscal deficits is an old theme, it still bears a good deal of truth. The Administration and Congress must take the necessary hard-nosed measures to reduce the Federal deficit. The current demand-pull inflation must be curtailed with the joint use of monetary and fiscal policy.

Otherwise, if monetary restraint is required to shoulder most of the burden of stabilization policy during periods of boom and inflation, then the entire country—including banks and their customers—will be faced periodically with sharp and disruptive changes in the cost and availability of money and credit. Moreover, the burden of

anti-inflation policy is then likely to fall unevenly on different segments of the economy. There must be a better approach to national efforts to achieve the goals of the Employment Act of 1946—"maximum employment, production, and purchasing power." It is incumbent on all of us to strive for a solution.

