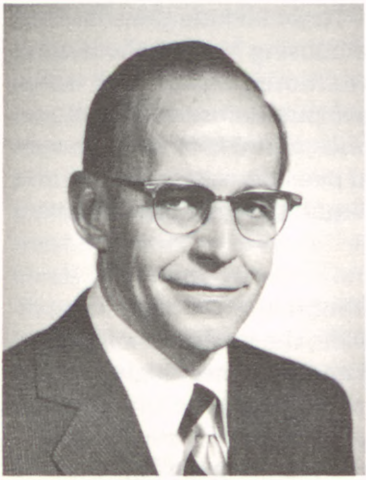
PROBLEMS OF INFLATION AND HIGH INTEREST RATES

Testimony of

John J. Balles

PRESIDENT
FEDERAL RESERVE BANK
OF SAN FRANCISCO

House Committee on
Banking and Currency
Washington, D. C.
July 17, 1974



John J. Balles

Mr. Chairman, I appreciate this opportunity to share my thoughts on basic monetary problems with this Committee. I will attempt to set forth and analyze what I believe are the major issues and the appropriate policies to deal with them. In that context, I will deal with the questions you raised in your letter of June 19. *

As you pointed out in calling these hearings, two of the most serious problems currently facing the U.S. economy are an unprecedented rate of peace-time inflation and a record high level of interest rates. The present inflation is especially pernicious because many of the largest price increases have been for necessities such as food, housing and fuels, so that the poor and those living on reduced retirement income have been hardest hit. Such perverse effects of inflation tend to negate the attempts of the government in recent years to assist such groups with direct govern-

*Letter printed at end of pamphlet.

ment programs. Similarly, it is clear that the current high level of interest rates has created serious dislocations and strains in our economy. These include the adverse impact on the housing market, the large capital losses to those persons in all walks of life who have put their savings into stocks and bonds, directly or through mutual funds and pension trusts, and the threat to the liquidity of financial institutions.

World-Wide Problem

As you are aware, the problems of rampant inflation and extremely high interest rates are not restricted to the United States. All of the major industrial countries are experiencing similar, or even higher rates of inflation, and the high interest rates which go with these rates of inflation. A significant share of our current inflation results from the fact that the prices of many basic goods—such as oil, wheat, cotton, and lumber—are determined in the international market place, rather than in the U.S. market alone. Thus, worldwide inflation acts to exacerbate and complicate our domestic inflation problem. For similar reasons, the resolution of our current inflation and high interest rate problems does not lie completely within our hands, but rather requires the cooperation of the major industrial countries of the world.

What has led to this unprecedented worldwide inflation? Some observers would cite excessive monetary and fiscal expansion as the major immediate cause. But since I do not believe that governments and central banks act out of blind ignorance or perverse motives, we must consider the social and political climate which tends to produce a bias toward inflationary policies. One major factor appears to be the increasing pressure on the world's available resources which has been created by a growing and more affluent population with ever-rising expectations for a higher standard of living. Another key factor appears to be the increased priority that governments have assigned to achieving a fully employed economy, both here and abroad, since World War II. Given this priority, governments have committed themselves to ongoing, expansionary domestic policies to prevent "unacceptable" levels of unemployment from developing. These secular developments have tended to create an underlying inflationary bias in government policies throughout the world.

The cultural and economic forces generated over the past three decades have provided the basis for our present inflationary experience, but they do not explain why serious worldwide inflation occurred in the first half of the 1970's, rather than the second half of the 1960's, or at some other period. The reasons for the timing of our problems are complex. However, one element which has not received as much attention as it deserves is the breakdown of the Bretton Woods System, and the decline in recent years in foreign confidence in the U.S. dollar. In the years from the end of World War II until the mid-1960's, the world looked on the U.S. as the strongest and most stable country, and the dollar as the strongest and most stable currency. As a result, both foreign governments and private persons tended to accumulate dollar assets. But as the U.S. suffered an almost unbroken string of deficits in our balance of payments, and as the U.S. inflation rate gradually accelerated in the late 1960's towards 6 percent, confidence in the dollar weakened, and there was an incentive to switch out of dollars into other currencies.

This movement out of dollars accelerated in the period after the U.S. suspended convertibility of the dollar into gold in August, 1971. The movement only came to a halt in March 1973, when most industrial countries floated their exchange rates, and thereby rang down the curtain on the Bretton Woods system of fixed-exchange rates.[1] In the period up to March 1973, foreign governments resisted an appreciation in value of their own currencies **vis-a-vis** the dollar because they believed that it would hurt their export industries, slow their growth, and create domestic unemployment. The consequent intervention in foreign-exchange markets by other governments substantially increased the domestic money supply in these countries as they bought dollars by issuing their own money through central bank operations. Thus the well-publicized dollar overhang was matched by foreign monetary expansion. Simultaneous monetary expansion in all major industrial countries helped to foster a simultaneous business-cycle boom around the world, which aggravated the inflation from which we all now are suffering.

Having noted the worldwide inflationary climate, I would now like to turn to a more specific analysis of the underlying factors that have produced rampant inflation in the United States, even in the face of a softening in economic activity. It may be helpful to put this problem in historical perspective, before attempting to assess possible cures.

---

1. "How Well Are Fluctuating Exchange Rates Working," Report of the Subcommittee on International Economics of the Joint Committee, 93rd Congress, 1st Session (Washington, D.C.: U.S. Government Printing Office), August 14, 1972.

Effect of Budget Deficits
Our domestic inflation problem owes much to the fact that the Federal Government in the United States has run deficits in 14 of the last 15 fiscal years. These deficits, which occurred in all phases of the business cycle, have expanded the Federal debt by $193 billion, or 67 percent since 1959. Federal deficits became an especially critical problem with the major escalation of the Vietnam war in mid-1965. The size of these deficits increased at an alarming rate during the Vietnam build-up period between 1966 and 1968 when the economy was at, or near, full employment. The fiscal situation was temporarily relieved by the belated income-tax surcharge in mid-1968, and by a leveling off in military expenditures at about the same time. However, the situation deteriorated further in 1969-70 when outlays for civilian programs outstripped recession-reduced revenues, and became still worse in the 1971-73 period when a full-blown expansion got underway.

It can be argued that a tighter monetary policy ought to have been able to offset the inflationary effects of this large, sustained deficit financing. In theory this may be true, but in practice the opposite has tended to occur. When huge Federal credit demands are added to those of a fully-employed private sector, interest rates tend to rise sharply. There are some sectors of the economy, such as housing construction, and programs financed with municipal bonds, that are especially sensitive to such a development because they depend heavily upon long-term credit. Because high interest rates have an uneven impact on the economy, demands for relief are quickly heard. For example, in the spring of 1973, there was a serious effort made by some members of Congress to freeze interest rates, or even roll them back to the level of January 1, 1973.

In short, large-scale deficit financing by the Government tends to bring great pressures on the central bank to keep interest rates from rising to "unreasonable," "unacceptable," or "dangerous" levels. Unfortunately, the only way that mounting credit demands can be satisfied without an increase in interest rates in the short run 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 action can generate inflationary pressures which may persist for a long period of time and result in even higher interest rates in the long run.

It has been my observation that large and persistent Federal deficits are a major factor in pulling monetary policy off course, in the direction of excessive monetary expansion, as the central bank attempts to cope with the conflicting pressures that develop. Too often in practice, therefore, an expansionary fiscal policy tends to generate excessive expansion in money and credit.

Priority of Employment Goal
The second major factor tending to inhibit the use of monetary policy in combatting inflation is the conflict in national goals that often occurs as between "full employment" and stable prices. Since the early 1960's, the "full employment" goal in the U.S. generally has contemplated an unemployment rate of 4 percent or less. Such a rate was regarded by many as a practical minimum, in view of the normal shifting of workers between jobs and the lack of marketable skills of some job-seekers. Whenever the conventional or aggregate unemployment rate has exceeded 4 percent,

pressures have developed for expansionary monetary and fiscal policies. For example, recently there have been demands for a tax cut to take up slack in the economy and to reduce our conventional or aggregate unemployment rate from the 5.2 percent level that prevailed last month. Were such policies to be undertaken, I greatly fear that they would simply accelerate the already extremely high inflation rate in the U.S.

In my view, there has not been enough policy use of a refined analysis of the employment and unemployment data, concentrating on the "hard core" of our labor force—i.e., heads of households or "breadwinners"—for whom the social and economc costs of unemployment are the highest. Among this group, the unemployment rate last month was only 3.1 percent, in contrast to the conventional or aggregate unemployment rate of 5.2 percent.

The significance of a 4 percent aggregate unemployment rate has gradually changed over time because of shifts in the composition of the labor force. An earlier study by George Perry of the Brookings Institution,[2] and a more recent study by Eckstein and Brimmer for the Joint Economics Committee[3] suggest that a 4 percent unemployment rate today represents a much tighter labor market than it did twenty years ago, in view of the increased participation in the labor market by teenagers and other

---

2. George L. Perry, "Changing Labor Markets and Inflation," Brookings Papers on Economic Activities, No. 3, 1970.

3. "The Inflation Process in the United States." Study prepared for the use of the Joint Economic Committee by Otto Eckstein and Roger Brimmer, (Washington, D.C.: Government Printing Office), February 22, 1972.

new entrants who also lack marketable skills. Generally, it now seems to take a higher rate of inflation to achieve a 4 percent unemployment rate than it did some years ago, because of those factors. Thus if we should now attempt to follow a monetary policy aimed at reducing unemployment to 4 percent, the likely consequence would be to exacerbate present inflationary pressures, which have already reached dangerous levels.

This, of course, is not to imply that monetary and fiscal policy should never be used to help deal with unemployment. What it does mean is that, because of shifts in structure of the labor force, there may be a change over time in the practical minimum unemployment target that can be achieved through expansionary monetary and fiscal policies without creating an unacceptable rate of inflation. Thus, some knowledgeable observers would hold that, because of the shift in the composition of the labor force already noted, the practical minimum target today might be about 4½-5 percent as far as measures to stimulate aggregate demand through monetary and fiscal policy are concerned.

In these circumstances, a very useful way to fight unemployment is to attack the structural source of the problem by helping to increase the marketable skills of those groups who lack experience. Such measures as low-interest education loans to youth and minority groups, retraining programs directed toward skills where job vacancies are high, and steps to facilitate worker mobility are all important in this context. Rather than imposing inflation on everyone by attempting to reach our employment goals through expansionary monetary and fiscal policies, our aim should be a much more vigorous use of selective means to deal with these specific problems. We need a high-powered rifle shot approach, rather than the shotgun approach of monetary and fiscal policy.

For whatever reason, there has been a tendency for the goal of "full employment" to take priority over stable prices, in view of actions in recent years by the Administration and Congress—whose job it is to determine national priorities. Not enough attention seems to have been paid to the trade-off—i.e., the additional inflation that must be accepted to get a lower unemployment rate. In essence, my argument is that we have had both a faulty diagnosis, and in part the wrong medicine, for the unemployment goal. First we need a more meaningful "target rate" for unemployment, as I have explained. Secondly, we need new perceptions and new remedies for structural unemployment, particularly among teenagers, minority groups and part-time women workers.

Lags in Monetary Policy Impact
A third major factor which tends to inhibit the use of monetary policy in combatting inflation, and which results in calls for its use to provide short-term stimulus to the economy, is a complicated technical one. Namely, the lags in the effects of a change in monetary policy seem to be shorter for production, employment and profits than for prices. Admittedly, our knowledge about the length of those lags is imperfect. But it is reasonably clear that the "good news" from easy money appears first, with production, employment, and profits expanding within, perhaps, 6 to 12 months. However, the "bad news" comes later, in the form of increased inflation with a lag of perhaps 1 to 3 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. In these circumstances, it is not surprising that elected officials who must face the voters at regular intervals tend to prefer an easy money policy.

Has Monetary Policy Been Too Expansive? Thus, it may be asked, has monetary policy been a principal cause of our inflation problem, with the accompanying high level of interest rates, and could this have been avoided if monetary policy had been tighter in recent years? In testimony earlier this year before the Congress, Chairman Burns acknowledged that, with the benefit of hindsight, monetary policy may have been overly expansive in 1972. Some of our critics, such as Professor Milton Friedman, would go much further—alleging that the money supply has grown too fast since about 1970, and that this played a major role in producing the current inflation.

Such criticism, whether or not fully justified, is easy enough to make, based both on monetary theory and statistical studies, but it seems to me to ignore real problems in the real world. No central bank can be or should be wholly independent of government. The elected representatives of the people of the United States, both the Congress and the Administration, must have the ultimate responsibility for economic policy. The Federal Reserve System must take account of the high priority which the Congress and the Administration have assigned to full employment and economic growth, which has often conflicted with stable prices. Central banks cannot completely ignore such imperatives —even against their better judgment. It is vital that this matter be thoroughly appreciated, not only by the Congress and the

Administration, but also by the business and financial community and the general public. It is only in this way that we can get support for the belt-tightening measures needed to overcome the corrosive problem of rampant inflation and sky-high interest rates.

Inflation and Financial Markets

Having dealt at length with "what went wrong," I would next like to deal with the pressing question of "where do we go from here." Specifically, I will attempt to assess the consequences of severe inflation for the economy and financial markets and the policy options available to deal with these problems. But first, I must emphasize the crucial role which inflation plays in causing high interest rates.

Interest rates, as the price of money, are determined by the supply and demand for funds, which in turn are critically influenced by inflation expectations. On the supply side, in a period of inflation lenders will expect an interest premium to compensate for the erosion by inflation of the value of their assets. On the demand side, the need for funds in a period of inflation is boosted by rising prices of new plant, equipment, inventories and consumer goods. Additionally, expectation that repayment will be in depreciated dollars will also add to demand for credit. The resultant heavy credit demands push rates even higher.

It is crucial to realize that the sharp escalation of interest rates in the first half of 1974 has occurred despite a continued growth in the money supply at a rate which some of our critics fear is still too large to be non-inflationary. According to latest estimates, the narrowly-defined money supply (M 1) rose at an annual rate of 7.0 percent in the first six months of 1974. Thus, the extremely high level of interest rates has stemmed principally from forces set in motion by inflation itself—i.e., by an inflation premium in interest rates and the way in which inflation magnifies credit needs.

In a very real sense, the double-digit inflation and accompanying high interest rates from which we are now suffering reflect inflationary policies of the past, the symptoms of which were temporarily suppressed during the period August 1971 to early 1973 by wage and price controls under various programs. Unfortunately, the inflationary process is not quickly reversible, and it will probably require several years to reduce the rate of inflation, and hence interest rates, to more reasonable levels. If sole reliance continues to be placed on monetary policy to do the job, unaided by fiscal restraint, it may take even longer. It is vital to recognize that rampant inflation cannot be brought under control without sustained monetary and fiscal restraint, in the U.S. or any other country. I believe that this conviction is shared by most economists of all schools of thought. Thus, the great challenge that we face in the process of licking inflation is to design the best measures to restrain demand and to increase supplies.

High and rising interest rates have taken their toll on financial markets. To the man in the street, some of the most obvious results have been the decline in the stock market and the sharply reduced supply of funds for home loans at savings institutions. These institutions have endured heavy withdrawals of funds, as depositors placed their funds in higher yielding market instruments, and the consequence has been a major curtailment of funds to the housing industry. To the man on Wall Street, the dangers have been just as ominous. For example, public utilities have experienced serious difficulties in raising money in the capital market, and the commercial banks have had increasing problems in raising funds to meet heavy loan demands.

The market disruptions caused by high interest rates, in turn, have seriously affected the real economy. Those who have invested in stocks and bonds, directly or through mutual funds and pension trusts, have suffered substantial capital losses, and have become poor sales prospects for new homes, new cars and other big-ticket items. And higher borrowing costs generally have contributed to higher prices of most goods and services.

One may certainly ask whether we must put up with such severe dislocations in the financial markets and the overall economy. Unfortunately, the answer to this question appears to be yes. A policy specifically aimed at reducing interest rates now would require massive injections of reserves into the banking system by the Federal Reserve and an acceleration in the growth of money and credit. The result might be a temporary levelling off or decline in interest rates, and a short-run rise in output. But in the longer run, this policy would cause an even sharper rise in prices, which in turn would cause interest rates to rise even higher.

Since high interest rates have had such painful consequences, it is pertinent to ask whether they have done any good in moving toward a solution to the inflation problem. I see mounting indications that the high cost of credit is having the desired rationing effect, both from the standpoint of borrowers and lenders, in "cooling off" the economy. This is a necessary first step in purging the economy of inflationary excesses and starting on the long road back toward stable and non-inflationary growth.

Policy Recommendations

What can policymakers do to extricate the economy from the present situation of surging inflation and high interest rates? I believe that several major lessons are implicit in what I have already said about the dangers of inflation and of unbalanced policy responses. However, these lessons can be summarized in the following four specific policy recommendations.

1. **Longer-term policy horizons.** Both with regard to monetary and fiscal policy, I suggest that we explicitly recognize the lagged effects of policy measures, and work within somewhat longer time horizons than has been the custom in the past. In our present uphill battle against inflation, we should expand our policy-planning horizons to at least three years to measure the effect of policy actions being taken currently. A planning horizon which does not capture the full consequences of current policy actions, especially with regard to prices, necessarily has an inflationary basis.

2. **Budget reform.** I applaud Congress' efforts this year in moving toward budget reform. By setting up new machinery that will deal with the budget as a single entity, you are in effect creating a vested interest devoted to the cause of economic stabilization. For the first time, Congress will be able to vote on fiscal policy. But beyond that, it seems essential to push for actual budgets which are restrictive in

periods of severe inflation. The best fiscal policy for fiscal 1975 would be at least a balanced budget, or preferably a surplus, instead of the $11.4 billion deficit currently projected. In my judgment, this is the most important single step that the Congress could take to relieve inflationary pressures and to reduce the level of interest rates. Up to the present, far too great a burden has been placed on monetary policy, with the anti-inflation effort centered around credit controls and the resulting high price of credit.

3. **Economic priorities.** I would recommend an amendment to the Employment Act of 1946, stating explicitly that price stability is a co-equal goal of economic policy, along with "maximum employment, production, and purchasing power." Further, I would suggest making explicit in policy decisions the implicit trade-off between full employment and stable prices whenever a conflict arises between these two goals. In the past, our laudable emphasis on the full-employment goal has caused us to downplay other necessary objectives, with the results we see today.

4. **Monetary policy.** If we are to overcome inflation, the Federal Reserve System must have Congressional and Administration support in pursuing a non-inflationary growth target for money and credit—even if high interest rates and some increase in unemployment are necessary in the short run, as inflationary forces are wrung out of the economy. It is particularly vital that we not be pulled off course toward excessive credit ease by the two major forces that have done so in the past—i.e., the necessity to finance large-scale budget deficits, and the tendency to call for easy money to solve structural unemployment problems that could be handled better

through selective measures of the type I've described.

Concluding Comments

My testimony, Mr. Chairman, has attempted to deal with the broad problems raised in your letter of June 19. Now I would like to conclude with a brief recapitulation directed specifically toward the six issues noted in that letter that involve some dispute in monetary economics. While recognizing that there are differences of opinion on these matters, both within and without the Federal Reserve System, my own views are summarized below.

1. **The reliability of the trade-off between inflation and unemployment as a guide for monetary policy.**
   The trade-off between inflation and unemployment seems to be unstable and subject to change. In recent years, it appears that the trade-off has worsened—i.e., it now takes more inflation to produce a given decline in unemployment. Even with the recent 11.5 percent inflation rate, the unemployment rate last month was 5.2 percent. Moreover, the trade-off appears to be a short-run phenomenon. In the long run, say, three years or more, a higher inflation rate will not "buy" a lower unemployment rate. Only in the short run of one to two years will we possibly observe a higher rate of inflation leading to a temporary decline in unemployment. This observation follows from the widely-accepted doctrine that in the long run the growth in the money supply affects only the general price level, while in the short run the principal effects are on production and employment.

2. **Benefits and risks involved in the Federal Reserve accommodating non-recurring price increases originating in supply shortfalls and other special events.**
It is my view that the Federal Reserve should seldom, if ever, accommodate price increases originating from supply shortfalls and other transitory events. This will do nothing to ease the supply problem, and by facilitating higher prices, it will contribute to a higher permanent rate of inflation. As Chairman Burns said last winter, we recently have had a shortage of oil, not a shortage of money, and we cannot increase the supply of the former by increasing the supply of the latter.

3. **The benefits and risks involved in monetizing deficit spending.**
As I indicated earlier, it is undesirable for the Federal Reserve to monetize the deficits of the Federal Government in periods of full or nearly-full utilization of resources. At such times, the monetization of Federal deficits tends to pull monetary policy off course toward excessive monetary expansion, and thus contributes to inflation. In periods of recession, on the other hand, it is appropriate and beneficial to monetize Federal deficits as part of a program aimed at recovery. Unfortunately, Federal budget deficits (as measured by the unified budget) have occurred in 14 of the last 15 years, irrespective of the state of the business cycle. There have been a number of important technical reforms in recent years, such as the auctioning of Treasury securities, which have reduced the Federal Reserve's role in support of the debt management area. However, the fundamental solution to the problem lies in

keeping spending in line with receipts, thereby eliminating the deficits when they are not needed to bolster a sagging economy.

4. **The benefits and risks involved in the Federal Reserve fighting money market fires.**
A primary function of any central bank is to act as the lender of last resort to protect the institutional integrity of the financial system. In this sense the Federal Reserve must "fight money market fires." Many scholars believe that a serious aggravating factor in the Great Depression was the Federal Reserve's failure to perform this function in an aggressive way. In my opinion, the Fed has done a creditable job in protecting the institutional integrity of financial markets in recent decades during periods of liquidity crises, without letting the money supply get out of control on the upside.

5. **Relationships between money supply, inflation and interest rates.**
The rate of growth in the money supply is a major influence determining the level of interest rates in both the short run of a few months, and in the long run of a few years. However, the nature of this influence is quite different in these two time periods, because of the role of inflation in these relationships. In the short run, accelerated money growth can force interest rates down, and restricted money growth can force interest rates up, by altering the short-run supply of funds relative to demand for these funds. However, short-run changes in money growth have little if any direct effects on the overall rate of inflation. In the long run, sustained changes in the rate of growth in the

money supply are a major determinant of the rate of inflation, and expectations of future inflation rates. Since current rates of inflation and inflation expectations are major determinants of the current level of interest rates, sustained changes in the rate of money growth will have a major effect on the level of interest rates. The lesson here is that efforts to reduce interest rates by accelerating money growth in the short run will be self-defeating in the long run. Thus, excessive easy money over a period of several years leads to inflation, which is a major factor producing high interest rates.

6. **How to use monetary policy to check inflation and to bring interest rates back down to reasonable levels.** Monetary policy can check inflation and bring interest rates back down to reasonable levels through a gradual but steady policy of reducing the rate of monetary expansion to a non-inflationary growth track. But to make this a viable approach, we will need a powerful assist from a policy of fiscal restraint, along with support for making stable prices a goal of equal importance with economic growth and full employment.

* * * * *

Committee Letter

June 19, 1974

Mr. John J. Balles
President
Federal Reserve Bank of San Francisco
San Francisco, California

Dear Mr. Balles:

We are scheduling hearings on inflation and high interest rates beginning July 8,

1974. Inflation and high interest rates are our country's gravest economic problem. Many believe that whether inflation continues to worsen or finally is checked and whether interest rates continue to soar or return to reasonable levels depends critically on what the Federal Reserve does.

A staff report based on interviews with the twelve Reserve Bank Presidents and five members of the Board of Governors is being prepared and will be presented at these hearings. The report focuses attention on several areas of dispute in monetary economics. In specific, the report calls attention to disputes over (1) the reliability of the trade-off between inflation and unemployment as a guide for monetary policy; (2) the benefits and risks involved in the Federal Reserve accommodating non-recurring price increases originating in supply shortfalls and other special events; (3) the positive elements and the risks involved in monetizing deficit spending; (4) the benefits and risks involved in the Federal Reserve's fighting money market fires; (5) the relationships between money supply, inflation, and interest rates; (6) how to use monetary policy to check inflation and bring interest rates back down to reasonable levels.

The Committee would benefit from your testimony on these questions. Please inform me at your earliest convenience about your availability during the weeks of July 8, July 15, and July 22 , 1974.

Sincerely,

Wright Patman
Chairman, Committee on
Banking and Currency
U.S. House of Representatives