PROSPERITY, PRICES AND PUBLIC POLICY

REMARKS OF

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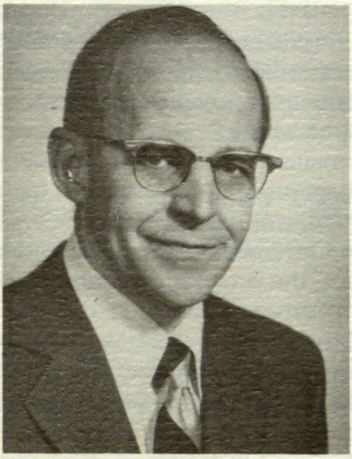

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I'm delighted to be back in Phoenix again, and I'm glad that the Directors and Officers of our Los Angeles Office have this opportunity to meet with Phoenix community leaders to discuss matters of common interest. Speaking as a resident of the Great Northern California Desert, I would say we might have a common interest in the subject of water. Actually, all I had in mind was taking a gallon or two home as a present for my family, but from what I've heard recently, your interest in the subject is more basic than that.

Needless to say, I'm no expert on the subject of the Central Arizona Project, but I must say that I was impressed with the recent set of editorials in the *Phoenix Gazette* which summarized the benefits obtained from Arizona's past efforts in the field of water development. The editorials, as you might remember, described how Federal-local participation in the Salt River

Project early in this century made the desert bloom like a rose (to coin a phrase), creating a prosperous metropolis where more than a million people now live and work. That project involved a Federal investment of about $10 million, but in the 20 years prior to the final payment on the debt in 1955, Valley residents paid more than 60 times that amount in Federal taxes. In more recent decades, the prosperity made possible by that investment in water resources has enriched the national and state treasuries by billions of dollars more, providing an example for all of us in the value of investment spending.

Most of my comments today concern the health of the national economy and the Federal Reserve's attempts to keep the economy healthy. We are certainly faced with some major problems, as Wall Street has been telling us recently. (In fact, gallows humor is back in vogue on the Street. Here's a sample: What's the difference between Wall Street and the Titanic? Answer: They had a band playing aboard the Titanic.) But on Main Street, despite serious fears of inflation, there's an underlying tone of strength in the production and employment statistics, as the business community builds upon the generally admirable performance of 1976.

Strength in 1976—and 1977

The past year admittedly had its problems, including the well-publicized "pause." But not enough publicity has been given to the fact that total output, in real terms, increased faster in 1976 than at any other time of the past two decades. Again, the year was marred by the continuation of a near-record level of unemployment—yet not enough attention has been given to the fact that no other period in recent decades, except the 1973 boom year, could match 1976 in terms of job expansion. Inflation also was a difficult problem in 1976, yet relatively few commentators remarked on the fact that the inflation rate had been reduced more than half in a two-year time-span. Unfortunately, their optimism may have been misplaced, in view of the double-digit inflation we've experienced in the last several months.

At any rate, the economy in early 1977 had a pretty strong foundation to build upon. As a result, my staff economists (like most others) originally saw the key 1977 estimates coming in at about "five-and-five," with real GNP growth of 5 percent or so, and an inflation rate of about 5 percent. Today, "six and six" may be a more realistic bet. Over the year, real GNP could increase almost 6 percent, especially in view of the rapid recovery from the big winter freeze. But unfortunately, most observers now see the 1977 increase in prices coming closer to 6 percent than to 5 percent—and some inflation-watchers foresee much worse. In contrast to the gradual deceleration of last year, we have experienced a worrisome speed-up in prices in early 1977, reflecting such factors as weather problems, fiscal problems, and the importing of foreign inflation. I'll have more to say on that in a minute.

The unemployment rate meanwhile should fall below 7 percent sometime this year, with or without any Administration tax stimulus, since basic expansionary forces should boost total employment about 3 percent for the second straight year—a very strong increase in historical terms. To get a good fix on the strength of the underlying economy, we should keep our eye on the doughnut instead of the hole; that is, on total employment rather than unemployment. Over the past two years, an expanding economy has created more than five million new jobs, roughly equivalent to six times Arizona's entire workforce. In contrast to these hard employment figures, the unemployment rate is a rather mushy figure for analysis and (especially) policy purposes. The statistics are inflated—in good times as well as bad—by women workers who move in and out of the labor force seeking temporary jobs, by teenagers who are priced out of the job market by high minimum-wage laws, and by some individuals who might not otherwise look for work but who are induced to apply for benefits because of liberalized unemployment-compensation laws. If we want an unemployment figure that reflects the actual health of the economy, we should look at the proportion of household heads who are out of work; that figure declined from an uncomfortably high 6.2 percent two years ago to a more reasonable 4.6 percent last month.

Post-Freeze Expansion

The actual shape of the economy this year was probably decided several months ago by the Big Freeze. Now, the Big Freeze of 1977 will be long remembered in folk mythology as one of the nation's most memorable physical disasters, but its economic effects may be short-lived, except for one thing. The severe winter interrupted and postponed a strong expansion that was evident around the turn of the year, and so it practically guaranteed a sharp rebound right about now. The recovery from the first-quarter shortfall, plus the continued growth of consumer and business demand, should generate a temporarily high rate of growth during the current quarter and set the stage for a healthy advance in late 1977 and early 1978.

The consumer was the hero of the 1975 recovery but for a while looked to be the villain of 1976's "awesome pause." But in late 1976 consumer spending strengthened again, and this pace has now been regained. Favorable consumer attitude surveys suggest one reason for further strength, but the major reason is the recent improvement in employment and consumer income. Homebuilding is another support of the expansion. Most of the earlier weakness in this market centered in multiunit construction, because of builders' widespread wariness over rental-unit prospects as a result of overbuilding and the specter of rent controls. But this sector of the market has begun to recover recently with the help of a boost in Federal subsidy programs, while single-family construction continues to show boom tendencies.

Business capital spending, a late arrival in this business expansion, is expected at last to show some strength this year. There is still some excess capacity in the economy, but that factor should be less of a constraint on spending plans as more and more capacity is called into play by the expansion in demand. For that matter, businessmen seem to be concentrating less on expanding capacity and more on modernizing facilities, as a means of offsetting cost pressures and improving profit margins. Meanwhile, business spending for inventories should expand gradually in line with the growth of other sources of demand, and thus should cease being the source of volatility in total spending that it has been throughout much of the last several years.

Inflation and Fiscal Policy
Generally, we seem to be faced with a very favorable situation, except for that one major fly in the ointment—inflation. The recent price statistics are indeed sobering,

even allowing for the special circumstances which pushed up prices at a double-digit rate in early 1977. Consumer prices have increased at a 6.5-percent annual rate since last fall—a full percentage point faster than in the preceding six-month period. Part of the problem is the weather-induced sharp rise in food costs, but the prices of other consumer goods have also accelerated, while the prices of services have continued to outstrip those of other consumer purchases. And households may expect further difficulties in coming months, since the wholesale prices of consumer goods have accelerated recently, rising at an 8.2-percent annual rate since last fall.

Many of the fears now expressed on Main Street and on Wall Street concern the price implications of the Administration's new energy program. That program recognizes the fact that energy has become relatively more expensive because of major shifts in basic supply-and-demand factors in the past decade or so. But we should remember that inflation does not simply reflect the rise in price of one single commodity, crucial as that commodity may be in our industrial society. Inflation is a rise in the general price level, and it has to be attacked by appropriate governmental policies—by overcoming supply bottlenecks, as the Administration proposes, and more basically by adopting moderate fiscal- and monetary-policy measures.

My own fears center around the long-term inflation threat created by the proliferation of Federal programs—and the consequent unprecedented string of substantial deficits—over more than a decade. The $112-billion combined deficit of the 1975-76 fiscal years might be explained in terms of the need to overcome recession, but how can we defend a deficit of like size in the expansionary 1977-78 period? The danger is that overly expansionary policies will rekindle inflationary expectations among consumers and producers—understandably enough, in the light of recent history—and that these inflationary expectations will distort purchasing decisions and undermine the long-run growth and stability of the national economy. In a word, a policy of heavy fiscal stimulus is risky and flies in the face of experience. All the research done by my research staff shows that with such a policy, the "good news" comes first in the form of increased employment and output, but "bad news" inevitably follows in the form of resurgent inflation.

Money and Interest Rates
Excessive fiscal stimulus tends to restrict the freedom of action of monetary policymakers, for we cannot afford to lean too far in the direction of short-term ease to stimulate economic activity as long as massive budget deficits still exist to generate new inflationary pressures. The Federal Reserve has made several adjustments over the past year in the long-run growth ranges for the monetary aggregates, partly to take account of the many changes in financial technology now affecting the financial system, but also to create the conditions for a return to general price stability. The latest announced projections include a growth range of 4½ to 6½ percent for M_1 (currency plus bank demand deposits) and a range of 7 to 10 percent for M_2 (M_1 plus bank time deposits except large CD's). But as Federal Reserve Chairman Arthur Burns has argued in several Congressional appearances, the long-run strategy calls for a gradual reduction in these monetary growth ranges in an attempt to unwind the inflation that still bedevils the economy.

The carefully fashioned monetary policy followed during the economic recovery period helped dampen inflationary expectations, and also helped finance the large gains in employment and output that I've already mentioned. Our policy, in addition, contributed to a general pattern of lower interest rates during 1975 and 1976. This of course is contrary to our usual experience during a period of cyclical expansion.

Yet here again, the Federal budget situation casts a cloud over the outlook. Federal demands on credit markets could be roughly the same this year as in calendar 1976, in contrast to the usual cyclical decline in such borrowing during a recovery period. That projected demand comes just at the time when private credit demands are rising, and thus generates significant upward pressure on interest rates when coupled with the demands generated elsewhere. On top of that, any inflationary fears created by continued large Treasury deficits obviously would cause lenders to try to get higher inflation premiums for their funds. These effects have already been reflected in higher interest rates in the first quarter of 1977, and I have difficulty seeing any reversal of that trend, at least as long as inflation jitters continue to dominate the money and capital markets.

An Independent Monetary Policy
Monetary policy, through its impact on the reserves held against bank deposits, helped support the growth of the economy during 1975 and 1976, while gradually squeezing out its inflationary excesses. In this endeavor, monetary policy showed itself to be far more effective than fiscal policy, which has several important drawbacks even apart from its creation of inflationary deficits. Manipulating government spending tends

to be a rather clumsy way of dealing with rapidly changing economic developments, while the process of reaching a consensus on needed tax changes usually turns out to be complex and time consuming. We've recently witnessed a vivid demonstration of that point, with continued discussion of expansionary programs long after the need for stimulus has passed.

Fortunately, monetary policy is relatively free of these shortcomings, because of its great virtue of flexibility. We can change monetary policy promptly and (if need be) frequently. The independent Federal Reserve can make the hard decisions that might be avoided by decision-makers subject to the day-to-day pressures of political life. And we've seen that when there are substantial changes in the supply of money and credit, the effects are speedily transmitted through financial markets to the nation's factories, farms and commercial enterprises.

The founders of the Federal Reserve System were well aware of the dangers that could arise from the creation of a monetary authority subservient to the Executive branch of government, and thus subject to political manipulation. Consequently, they took several steps to ensure the independence of the central bank within the structure of our Federal Government. For example, Board members have 14-year terms of office, long enough to minimize the threat of political pressure, and they also have staggered terms to avoid Presidential "packing" of the Board. Again, the Federal Reserve accounts for its actions to Congress, and not to the Executive branch of government. But in this connection, the Fed's operations are financed from its own internal sources, and thus protected from the political pressures that may be exercised through the Congressional appropriations process.

This system of monetary management seems to be working just the way the founders of the Federal Reserve intended. Certainly, the Fed has stumbled on some occasions, but it's hard to imagine that our problems would have been solved if we'd followed the suggestion of the Fed's critics and turned control of the monetary authority over to the Executive branch or to Congress. Specifically, if the spending propensities of Federal officials had been given freer rein through easier access to the "printing press," our inflation problem of the past decade probably would have been aggravated even more.

Every nation in the world has suffered severely from inflation in recent years. But it's interesting to note that the two industrial nations with the strongest central banks—Germany and the United States—are also the two with the strongest records of curbing inflation. Great Britain, whose central bank was taken over by the Government several decades ago, has recently suffered from a chronic case of double-digit inflation, with prices rising at times at a rate of 20 or 30 percent a year. In some other countries, in Latin America and elsewhere, where the monetary authority has always been dominated by the executive or the legislature, triple-digit inflation holds sway, bringing economic and political chaos in its wake.

In our democratic society, of course, the independence of a governmental agency can never be absolute. The Federal Reserve is subject not only to the Federal Reserve Act, but to other statutes as well. The founders of the System recognized this duty by requiring the Fed to account for its stewardship to the Congress. As you know, we now have a formal reporting system, with Chairman Burns traveling up to Capitol Hill once every quarter to discuss the course of monetary policy, including growth projections for the major monetary and credit aggregates for the year ahead. The present system is effective because it provides ample scope for the exercise of Congressional oversight, yet keeps political pressures away from day-to-day involvement in the details of monetary policy.

Concluding Remarks

To sum up, the national economy is in relatively good shape today, with production, employment and retail sales pointing upward, and with manufacturers' order-books growing increasingly bulky. Indeed, the present solidly-based expansion could continue for the rest of the decade if only—and it's a big if—we could get prices under control. And as I've suggested, one of the best ways to stop inflation is to get the Federal budget under control, thus reducing the pressure on the Federal Reserve to finance those deficits through the printing press, and reducing the pressure on financial markets induced by heavy Treasury borrowing.

The Federal Reserve has a major role to play in the fight against inflation. To help the economy recover from a serious recession, we earlier adopted monetary growth ranges which were considerably higher than they should be over the long run. Ideally, the increase in the money supply (along with the increase in turnover of that money supply) should approximate the long-term growth rate of physical output, which is about 3½ percent a year. Now that the recession has been overcome, we are determined to move towards a gradual reduction in the growth of the money supply. To do so, however, we must be able to maintain our present independent policy stance, free of short-term political pressures. Otherwise, if those pressures for perpetual rapid expansion should succeed, we would have few defenses left against the destructive inflation that has brought chaos to so much of the world.