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POLICY OVERVIEW FOR 1978

REMARKS OF
John J. Balles

PRESIDENT
FEDERAL RESERVE BANK
OF SAN FRANCISCO

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John J. Balles

The best hope for prolonging the recovery and lowering the unemployment rate is to reduce the underlying rate of inflation, according to Mr. Balles. This policy prescription flows from the research finding that the goals of reduced unemployment and lower inflation are mutually reinforcing, not conflicting. This finding implies for 1978 that we should pursue a gradual reduction in the growth rates of the monetary aggregates. Moreover, there is no need for a more expansive policy despite recent signs of sluggishness in the economy. For one reason, monetary policy already has been very expansive this year. Again, excessive ease at this point could prove dangerous, as it would have been in the similar brief pause of late 1976.

I am pleased to have this opportunity to discuss the appropriate monetary policy for the coming year, since we are approaching a critical phase of the current economic recovery. That recovery is now in its tenth quarter, yet only one of the post-Korean War expansions has lasted more than thirteen quarters. I do *not* want to imply that the current expansion is likely to end soon. On the contrary, I happen to believe that we are capable of repeating the experience of the 1960's, when we enjoyed nearly a decade of sustained economic growth. Whether we will in fact experience another such prolonged expansion will depend crucially, in my opinion, on the various policy choices we make.

Still, choices are difficult in view of a basic policy dilemma. On the one hand, despite ten quarters of solid economic growth, the overall unemployment rate still hovers around 7 percent. Although the rate for household heads is only 4.6 percent, the rates for minorities, women, and teenagers are disturbingly high. On the other hand, despite these signs of slackness in labor markets, the underlying inflation rate still appears to be at least 6 percent. The persistence of high inflation suggests that a policy of restraint is in order; the persistence of high unemployment argues for a policy of more stimulus. The arguments for a more expansive policy have recently been buttressed by fears that the recovery may be running out of steam.

Unemployment-Inflation Trade-off?

Most of the discussions of whether it is time for more stimulus or more restraint are couched in terms of a *trade-off* between unemployment and inflation. It is generally assumed that we can reduce unemploy-

ment if we are willing to put up with a bit more inflation, and vice versa. The question then becomes: Which is the greater evil, inflation or unemployment? The costs of unemployment—individual hardship, lost output, and social tensions—are obvious. The costs of inflation are equally serious but more subtle, including such things as the erosion of household savings, the damage to those on fixed incomes, and the creation of distortions in financial, factor, and goods markets. Not surprisingly, attempts to weigh these costs against one another tend to generate more heat than light.

A side issue, yet an important one, is the need to interpret the unemployment figures in the light of a changing labor force. With the large influx of women and teenagers into the labor force, the relatively high levels of unemployment traditionally experienced by these groups have raised the overall unemployment rate. This fact is surely not a reason for complacency about the unemployment situation. But it does suggest that, to a large extent, today's high unemployment rate reflects the economy's difficult adjustment to a major secular change. For example, last year the Council of Economic Advisers raised its estimate of "full employment" from 4.0 to 4.9 percent unemployed. It would be wrong for policymakers to respond to these structural changes in the economy with expansive measures designed to combat cyclical downswings. The best policies to help the economy through this transition are those aimed at promoting stable, sustainable growth.

While recognizing that changes in labor-force composition might go far toward resolving the current policy dilemma, I wish

to focus your attention today on an even more basic point. Specifically, I would argue that the very notion of a trade-off between unemployment and inflation is fundamentally misleading. Recent evidence suggests that under some circumstances, inflation may tend to *increase* rather than to *decrease* joblessness. Research done at my bank by Joseph Bisignano—which appears in the Summer issue of our *Economic Review*—gives such evidence for the U.S. Recent experience in Great Britain, Canada, and Italy suggests similar results. This perverse impact of rising prices on unemployment can be explained by the reactions of both consumers and producers, who associate inflation with increased uncertainty about the future. Households, more uncertain about the future value of their real incomes, tend to cut back on their spending plans. Businesses, more uncertain about the rate of return on new capital, tend to reduce investment in plant and equipment. The actions of both groups lower aggregate demand and thereby tend to raise the jobless rate.

Since the relationship between inflation and unemployment is central to my policy prescription, let me take a moment to examine it in more detail. Economists of such different persuasions as Milton Friedman and Franco Modigliani now agree that there is no long-run trade-off between inflation and unemployment. (For example, that agreement was clear in the debate between those two economists at the San Francisco Fed, which was published as a supplement to our Spring *Economic Review*.) But most economists probably still feel that an unexpected increase in the inflation rate will lead to a short-run reduction in unemployment. As businesses see

that they can get a better price for their products, they would be encouraged to hire more workers to increase output. However, the research by Bisignano, which I alluded to, suggests that this positive *supply* response will be quickly undone by reactions on the *demand* side.

Impact on Consumers and Producers

Briefly, the unanticipated inflation leads consumers to spend less and to save more, as a hedge against uncertainty. As they do so, the increased output of producers piles up in the form of unintended inventory accumulation, and then businesses scale back their production plans and begin to lay off workers. Again, in this inflationary environment, producers find it more difficult to gauge the profitability of new investments in plant and equipment, and they consequently hold off on their capital-spending plans.

The effects of inflation on personal savings and, hence, on unemployment, became strikingly evident during the 1973-75 recession. That recession was not only the most severe of the past generation, but the preceding inflation had no parallel since the price upsurge following World War II. First, the U.S. suffered from a worldwide inflation which peaked domestically at nearly a 14-percent rate in late 1974. A large part of that inflation was unanticipated. As the rate of inflation increased, so did the rate of personal savings. And, as the inflation declined in 1975-76, the savings rate followed it down and consumer spending then recovered dramatically.

In 1974, an absolute reduction in real consumption spending contributed to a sharp build-up in inventories. But part of that

build-up could be explained as a speculative response to expectations of further increases in materials prices. Some of it no doubt also reflected producers' difficulties in making sound management decisions at a time when rapid inflation was rendering cost-accounting figures meaningless. By the time that the need for an inventory correction finally became evident, the size of the adjustment was much greater than it would have been if producers had cut back sooner. The result, of course, was a severe plunge in real output.

If rapid inflation causes businesses to overinvest in inventories, it has, on balance, a depressing effect on capital spending decisions. It *may* boost plant and equipment expenditures temporarily as businesses accelerate those investments they have already decided to undertake, so that they can get the new facilities at a better price. But as inflation persists, it makes businesses (like consumers) more uncertain about the future. Will price controls be imposed to stop the inflation? Will fiscal and monetary policy suddenly turn sharply deflationary? Will consumers cut back on their spending plans? All of these unknowns increase uncertainty about the expected return on any proposed investment. And the more doubtful a business becomes about future profits, the less likely it will be to commit resources to long-term investments. Yet increased investment is vital to the creation of more employment opportunities.

A clear message for policymakers emerges from this discussion—namely, that the goals of reduced unemployment and lower inflation are mutually reinforcing, not conflicting. The best policy is one which aims at a continued, gradual reduction in the under-

lying rate of inflation. Such a policy provides our best hope for prolonging the recovery and lowering the rate of unemployment.

Monetary Policy Prescription

What does this general prescription imply for monetary policy? Quite simply, that we should pursue a gradual reduction in the growth rates of the monetary aggregates, to a level consistent with long-run price stability. This is the course on which the Fed set out in March 1975, when it began the practice of making quarterly reports to Congress regarding our targets for monetary growth over the year ahead.

But what about the signs of a faltering recovery, such as this summer's softness in retail sales and durable-goods orders? Shouldn't monetary policy become at least slightly more expansive in the face of such indications of softness? My answer to that is "No," for two reasons. First, monetary policy has already been very expansive in 1977. In the past twelve months, the narrow money supply, or M₁, has grown over 7 percent. The more broadly defined money supply, M₂, has grown almost 11 percent. These rates are not only high by historical standards, but are also above the upper bounds of the current targets which the Fed has set for long-term monetary growth.

But—and here I come to my second reason—suppose we were to expect a slowdown in real growth in the months ahead, despite the recent record of generous monetary growth. In that case, I still do not believe that any special actions by the Fed would be called for. Recall what happened about this time last year, when many observers became alarmed about the "pause"

and called for a change in monetary policy. Had the Fed responded to the slowdown in the second half of 1976 with a more expansive policy, the effects would have been felt in the first half of this year, when the economy was booming and inflation reaccelerating. In retrospect, it is clear that the "pause" was really a mini-inventory cycle. Although real GNP growth slowed to 1.2 percent in the fourth quarter of 1976, real final sales were increasing at a rate of 6.3 percent. As a result, inventories were brought back into line quickly, and the recovery proceeded. I do not believe that monetary policy should try to offset quarterly variations in economic growth caused by such mini-inventory cycles. Instead, I believe that it must aim at establishing a stable environment conducive to sustained economic expansion over the long haul.

Fiscal Policy Prescription

Needless to say, monetary policy cannot do the job all by itself. When fiscal policy results in chronic, massive budget deficits, the Fed comes under tremendous pressure to provide more reserves to the banking system to help finance such deficits. This reserve expansion increases the rate of monetary growth and ultimately leads to more inflation. The independence of the Fed within the government gives it some room to resist these pressures. But if we are to bring inflation under control, it will be necessary for fiscal policy to complement monetary policy. The achievement of fiscal restraint is perhaps the greatest policy challenge in the years ahead.

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