

## A MONETARIST OUTLOOK

Speech by  
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It is good to have this opportunity to present an analysis of the current economic situation and outlook to this meeting of Security Analysts. As you are probably aware I am a member of a new and growing segment of the economics profession, frequently referred to as "monetarists." My enthusiasm after accepting this invitation has been increased because of the new economic stabilization program, and because much of the recent discussion in the financial press has been quite critical of my school of economic thought. I would like to take this opportunity to review briefly some of our basic beliefs, to present my analysis of the current situation and near term outlook, and to discuss some possible longer term stabilization courses.

Most criticisms of monetarists have been general and vague. Some question that if these beliefs are correct, why hasn't the economy expanded more rapidly in view of the recent sharp jump in the money stock. Some have been annoyed that the Administration did not do more with taxes or Government spending; the

suggestion is that they relied too heavily on the recent monetary expansion. A few have been disturbed by interest rate gyrations, preferring to blame them on increased emphasis on money in policy implementation.

Paul Samuelson in a recent Newsweek editorial stated and I quote, "It is no secret that the forecasting ability of monetarists is selling at a huge discount on the markets of informed opinion." End of quote.

Of course, I do not claim that all forecasts based on developments in money are accurate, or that any are ever going to be perfectly correct. We live in a world of such uncertainty, as security analysts know. In addition, some projections have been based on assumptions of monetary or fiscal actions which never materialized. This is an ever present hazard of forecasting. Assumptions underlying a forecast are easily forgotten, but the forecast itself may be remembered.

In order that you might better judge the forecasts emanating from the Federal Reserve Bank of St. Louis and our policy recommendations, I will take a few minutes now to present some of our basic premises and to review the record of our projections. All were available to the public at the time they were made in speeches, the Bank's Review, or other releases.

Premises

The monetarist beliefs are based on traditional economic doctrines which were dominant for many decades prior to the "Keynesian Revolution." One of the basic premises of this approach is that the economic system is basically stable, which is in sharp contrast to the Keynesian beliefs that counter-cyclical Government actions are essential to promote high level employment and stable prices. Monetarists view most Government stabilization efforts as a source of instability.

Another basic premise is that the Federal Reserve System, through its control of the money stock relative to the demand for it to hold, exercises a pervasive influence on the course of total spending, and thereby on prices. Hence, monetarists, attribute much of the destabilizing movements in total spending and the inflation to inappropriate monetary actions.

Federal Government spending and taxing actions, alone, are held to exert little net influence on the trends of total spending or prices over a year or two. Deficits created by changes in tax rates or Government spending must be financed by borrowing. Such borrowing tends to cause offsetting movements in private spending unless accompanied by a change

in the money stock. Hence, monetarists do not directly attribute much of the excessive growth in total spending and the acceleration of price increases during the late Sixties to the expenditures for Vietnam, the expansion in Government welfare programs, or the inadequacy of tax rates. Instead, we attribute these economic developments to the method used to finance expanding Government programs -- that is, by monetary expansion. Government fiscal actions may affect income distribution and real growth rates, and have a relatively minor effect on the time path of total spending. However, they should not be blamed for causing business cycles or influencing the pace of inflation, except as they are reflected in the rate of monetary expansion.

Another premise is that trends in prices respond only slowly to changes in monetary developments. This sluggish response has caused many to question the effectiveness of monetary actions in curbing inflation. Investigations at the St. Louis Federal Reserve Bank have found that monetary actions have their effect on total spending with a lag distributed over about five quarters. When total spending does finally slow, growth of output of goods and services is initially reduced also, but it is at least three more quarters before significant progress begins on prices. We estimate that the entire process of of curbing inflation (with

production gradually returning to its high level equilibrium) under a favorable monetary climate would take 4 or 5 years. The inflationary build-up required a similar period. As the inflation becomes stronger and more imbedded in the public's contracts, thinking and anticipations, the process of eliminating it becomes progressively more painful and more time consuming. Controls or freezes may have some effect in revising the public's anticipations for a time, but controls must be reinforced by sound monetary actions if they are to be truly effective over a considerable period.

#### Experience in Forecasting

A review of monetary developments and subsequent economic events illustrates the soundness of these fundamental premises. A marked and sustained change in the rate of change of money has almost always been followed by a change in the growth rate of total spending in the same direction. Because of this fundamental relationship, monetarists have generally been successful in forecasting broad cyclical movements in total spending for goods and services. Changes in spending, in turn, have usually caused parallel changes in production initially, but over a prolonged period, production moves back toward

its equilibrium rate of growth, and the entire impact of the change in spending trend is ultimately on prices.

In the March 1970 Review of the St. Louis Bank, money growth rates and cyclical movements in economic activity, as determined by the National Bureau of Economic Research, were compared for the period 1913 through 1969. The record clearly indicates that marked and sustained changes in the rates of growth of money were usually followed after a brief lag by cyclical movements in business activity in the same direction.

A similar result, using more sophisticated tests, for the 1953-68 period was reported in the November 1968 Review. One conclusion of that study was that monetary influences had a stronger, more predictable, and faster impact on economic activity than fiscal influences. Later studies covering the 1919-69 period for this country (reported in the November 1969 Review) and the experience of eight foreign nations (reported in the February 1970 Review) gave broader confirmation to the earlier conclusions.

In recent years, there have been three occasions when forecasts of monetarists were markedly different than the standard forecast. In each case, the economy has moved along the general lines that monetarists had projected.

The first of the three occasions was in the fall of 1966. Money had remained on a plateau

since the spring of the year, after rising markedly from 1964 to early 1966. Based on this marked and sustained slowing in money creation, monetarists anticipated a marked reduction in spending growth in early 1967, with the initial impact on production. The consensus forecast at that time, based on a Keynesian approach, was for continued rapid economic expansion. Government spending was growing rapidly both for war materials and welfare programs causing rising Federal deficits. It was reasoned that this investment would operate with a multiplier expanding economic activity. As you know, the monetarists were correct, the first half of 1967 was a period of marked hesitation, called the mini-recession.

A second marked difference in projections occurred in the late Summer of 1968. The consensus group anticipated considerable slowing of economic activity in late 1968 and early 1969 as a result of the 10 per cent surtax and some cutbacks in the growth of Federal spending. A fear of "overkill" gripped the economic profession. In the August 5 issue of U.S. News and World Report, Arthur Okun, the President's chief economic adviser, stated and I quote, "I know of no one who would say now that our worries are still

those of expanding too fast. If anything the balance has shifted a bit in the other direction." End of quote. Yet, monetarists, based on the continued rapid growth in the money stock, correctly projected the continued excessive growth in total spending during the remainder of 1968 and early 1969, which in turn, caused an intensification of the inflation.

A third distinct difference in projections occurred during 1969. By that time both monetary and fiscal actions had become less expansive, and most observers expected sluggishness in spending and production. Many thought in addition, that inflation would quickly dissipate once excessive total demands were eliminated. For example, the President's Council of Economic Advisers in their 1969 Annual Report projected a slowing in inflation from the 5 per cent annual rate to about a 3 per cent rate during 1969. More recently, in view of the lack of progress on reducing prices, the Chairman of the Board of Governors of the Federal Reserve System, in testifying before the Joint Economic Committee of Congress on July 23, 1971, stated that "The rules of economics are not working in quite the way they used to."

The monetarist position, by contrast, has consistently been that the road to curing inflation



would be long and costly, requiring great perseverance. The forecasting model of the Bank, the results of which are available in our "Quarterly Economic Trends" release, has always projected a very slow decline in the rate of inflation. In a talk to the Argus Economic Conference in November 1969, I concluded that: "I am sorry that I cannot present to you a view which maintains that inflation is fairly easy to conquer within a year or so. We should remember that our present inflation was permitted to develop at an accelerating rate over the past five years. It is rather presumptuous to assume that this trend can be reversed in a year or so, or that the cooling-off of inflation can be achieved in a reasonable time without a period of very slow growth in output and higher unemployment. Overly optimistic pronouncements of our ability to curb the present inflation in a hurry and with only slight effects on employment are a disservice to our people and a stumbling block to the working of orderly corrective processes."

Current Economic Situation and  
Near-Term Outlook

Let us now turn to the current economic situation and the near term outlook. The economy

is suffering from both inflation and a less than full utilization of labor and other resources. The inflation, as the monetarists see it, was caused by an excessive growth of the money stock in the late 1960's. From 1957 to 1965, money growth averaged 2.3 per cent per year, and inflation was nearly nonexistent. From 1965 to the end of 1968 money growth accelerated to about a 6 per cent rate. Reflecting the jump in cash balances, the growth of spending accelerated. Since the economy was producing at near capacity, much of the spending growth was translated into higher prices. Rising prices caused a large redistribution of real income and wealth, and as a defensive measure the public gradually imbedded the price rise into contracts and other anticipations. Hence, the inflation developed a strong momentum; the effects of which are referred to by some as cost-push. Therefore, even though excessive total spending was eliminated about mid-1969, the inflation has continued, giving ground only gradually.

During 1969 the money stock grew 3 per cent, or at approximately the long-run trend rate. With a brief lag, growth in total spending slowed to about a 5 per cent annual rate, a pace sufficient for the trend growth in productive capacity with

little inflation. However, reflecting the strong upward momentum of prices, the initial impact of the slowing in spending centered on production and employment. Production changed little from mid-1969 to late 1970, and unemployment rose to about 6 per cent of the labor force. Nevertheless, these transitional costs were much less than in previous periods when inflation was resisted effectively.

In an attempt to reduce costs of resisting the inflation, monetary policy was relaxed in 1970. It was anticipated that continued downward pressure could be applied to the inflationary situation while reducing the transitional burdens on production and employment. The money stock was increased about 5-1/2 per cent in 1970. As monetarists expected, total spending, which had been rising at a 5 per cent annual rate, accelerated moderately -- actually to an 8 per cent rate since the third quarter last year. Again, the major initial impact has been on production. Despite the more rapid growth in money and spending, the evidence indicates that some downward pressure has remained on prices. However, relaxing the intensity of the battle against inflation logically means that the struggle must be endured longer. In addition, since the recent 8 per cent growth in total spending is not

likely to be consistent with long-run price stability, another step in monetary tightening, with its adjustment costs, will still be necessary if price stability is eventually to be achieved.

In early 1971, the growth rate of the money stock again accelerated, and quite markedly. Since January the growth of money has risen to the highest rate in several decades -- 11 per cent per annum. Increasing concern about the continued 6 per cent unemployment rate, plus the emphasis on money market conditions in policy implementation, were largely responsible for the marked shift to rapid monetary expansion. The facts that the unemployment rate usually lags in a period of economic recovery, and that money market conditions as a guide to short-run monetary actions have frequently been misleading, were ignored. The economic consequences of the recent monetary expansion have not yet had time to be felt.

Experience indicates that much of the anti-inflationary benefits of the 1969-70 slowdown probably have been dissipated, and if money is not slowed quickly inflation may gradually accelerate next year.

The near-term economic outlook as seen by monetarists, is for expansion. Based on the moderately expansive monetary conditions of 1970 and the sharply accelerated growth of money since

January this year, growth in total spending is likely to accelerate in the next six months. Greater spending should be accompanied by increases in production, incomes, corporate profits, and employment. Real progress against inflation will probably be slow because of rigidities in the wage and price structure, the role played by price anticipations, and the rapid injection of money since January. As a result of the current freeze, our published price indexes will certainly show a slower rate of inflation during these fall months. However, the attainment of lasting price stability is dependent on the achievement of a moderate sustainable rate of growth of money.

The longer-term outlook, as the full impact of our excesses are felt, is not favorable. Inflationary anticipations, which were already strong at the beginning of this year, have been reinforced by the large monetary injection this year. This makes the ultimate attack on inflation all the more difficult. Growth rates of money must be slowed if real price stability is ever to be achieved; in fact the growth of money must be slowed from the rapid rate of early 1971 to avoid an acceleration of prices in late 1972 and in 1973. A material slowing in monetary expansion, however, is likely to be followed in about

six months by another hesitation in spending and production growth and a rise in unemployment. In short, after two costly experiences in fighting inflation (the mini-recession of 1966-67 and the recession of 1969-70) we still are faced with the problem. These earlier experiences were both aborted by excessively expansive developments just at the point when significant progress was being made in reducing the rate of inflation.

#### Concluding Remarks

In conclusion monetary actions, measured by changes in money, are important. Experience both in this country and others indicates that the trend growth of money is the major cause of price inflation. Also, marked and sustained changes in the growth of money are usually followed by short-run changes in production and employment.

The economy will receive a great stimulus in the next nine months. Spending, production, income, employment, and corporate profits will all probably rise at a relatively rapid pace, reflecting the initial stimulus of the recent rapid monetary injection. At the same time, the rate of price increase will probably slow, as a consequence of the initial effects of

the freeze as well as delayed effects of the moderated monetary actions of 1969 and 1970.

The longer-term outlook is not bright. Because of the monetary excesses of 1965 through 1968 and, again, in 1971, inflation has developed great momentum. Inflation causes many inequities, and its removal will be painful.

As I see it, economic activity in the decade of the 1970's will proceed along one of four courses, none of which will avoid hardship.

One possible course is a severe prophylactic depression. Since this approach to abolishing inflation seems unduly costly and can be avoided, it is the most unlikely course.

A second course, at the opposite extreme, would be to accept the current, or perhaps even intensified, inflation more or less permanently. This course would probably result in the highest real costs for society over the decade of the 1970's, and, strangely enough, this scenario is a likely one. It's likelihood is based on the fact that short-run real benefits to society can usually be increased by more expansive monetary policies, while the longer-run costs of such actions are seldom understood or given much weight in policy decisions. Redistributions of income and wealth from a continued or accelerating inflation would be huge.

In addition, under such a course the economy would likely continue to suffer cyclical movements in production and employment and increased controls, as periodic efforts would be made to resist or moderate the inflation.

A third course would be to follow a steady rate of monetary injection consistent with maximum growth in long-run real income without inflation. Such a course might involve another moderate transitional slowdown plus several years of production at less than potential, but in the long-run it would probably be the least costly of the alternatives available. Such a course would require great statesmanship by policymakers and perseverance by the public.

A fourth course would be to maintain continually some downward pressure on inflation, while attempting to avoid major cutbacks in the growth of production. Such a result might flow from a very gradual slowing of the rate of money creation over a prolonged period until the long-run optimum rate is reached. This compromise approach to extinguishing inflation has appeal but has the disadvantage of prolonging the transitional costs, requiring even more perseverance than a more aggressive attack.

Because the long-run outlook appeared so bleak, many advocated, and the country adopted, a wage and price freeze. The initial response to the



freeze has been heartening to those recommending this course. Such actions however, do not get at the source of inflation and may create additional problems of their own unless adequately bolstered by sound monetary actions.

Recent experience has again demonstrated the truth of the following monetarist propositions.

1. The trend growth of money should be moderate - otherwise inflation results.
2. Growth of money should be steady -- otherwise cyclical fluctuations in spending, production, employment, and profits result.
3. Emphasis on short-run economic goals (fine tuning) leads to intensified inflation since real benefits can usually be increased for a time by more expansive actions.

The monetarist prescription for the economy involves transitional costs, but I am unaware of any better approach to achieving our long-run stabilization objectives.