

## CURRENT ECONOMIC SITUATION

### The Fed's Influence on the Outcome of the President's Program

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I am pleased to have this opportunity to present to you some of my views regarding attempts since 1968 to restore stability in the American economy. We presently find our economy, as well as the world economy, in a serious state of disarray. First, let us examine briefly our major economic problems.

#### Economic Problems

In the last six years, the American economy has suffered a high and accelerating inflation. This inflation has proven very difficult to bring under control. The rest of the world has also faced serious inflation, with leading industrial countries experiencing very rapid price rises.

Interest rates in the United States have been at historically high levels for much of the last six years. However, it was not until the late 1960's that interest rates surpassed those of the early 1920's.

Accompanying the high and rising interest rates and the inflation, there have been many serious problems in the financial markets. Problems have included financial "crunches" and disintermediation of funds from our savings institutions into money market instruments. The housing industry and small businesses have been particularly hard-hit by these developments. The stock market also underwent a major downward adjustment in the late 1960's and in early 1970.

Unemployment has been relatively high for two years, but this unemployment has not been as large as in other recessions in the post-World War II era.

The nation's balance-of-payments position has been deteriorating for the past ten years with respect to other major industrial countries. The first nine-month figures indicate that the year 1971 may show the first trade deficit that our country has experienced since 1893. Repeated crises have occurred in foreign exchange markets, which in turn, have led to increased restrictions to the free flow of international trade and finance.

This sad state of economic affairs has developed despite a supposed better understanding of economic processes and well meaning attempts to fine-tune the American economy. In the decade of the 1960's, economists had high hopes for the use of traditional monetary and fiscal tools for promoting high employment price stability, and a viable balance-of-payments. It became very fashionable to claim that we could turn the American economy around on a dime. In the early and middle 1960's most confidence was placed on the use of fiscal actions, that is, changes in Federal tax rates and spending. Later in the decade, as the power of fiscal actions began to be questioned, more stress was placed on the use of monetary actions, that is, managing the nation's money stock.

## The New Economic Program

Our recent experience with the prolonged simultaneous occurrence of high inflation and high unemployment, has led to a widespread disillusionment with traditional tools of economic stabilization. As a result, a drastic new program has been developed for the American economy. This program includes restrictions of price and wage movements for the control of inflation. First, there was a complete price-wage freeze, and more recently we have had the announcement that in Phase II there will be price and wage restrictions. Fiscal actions have been proposed to stimulate the domestic economy, and major actions have been taken to improve our balance-of-payments position, pending a basic reappraisal of the international payments mechanism.

## Background

In attempting to analyze our present economic situation, I find it useful to examine the history of our current state of economic disarray. Such a review should provide us with insights into the causal forces and likely cures, and aid us in preventing the same events from happening again.

First, I will examine the main cause of our economic dislocations, as we at the St. Louis Federal Reserve Bank see it. This will be followed by a discussion of the forces which allowed this basic cause to come into existence. And, finally, there is an analysis of what I believe to be the basic requirement for success in restoring economic stability.

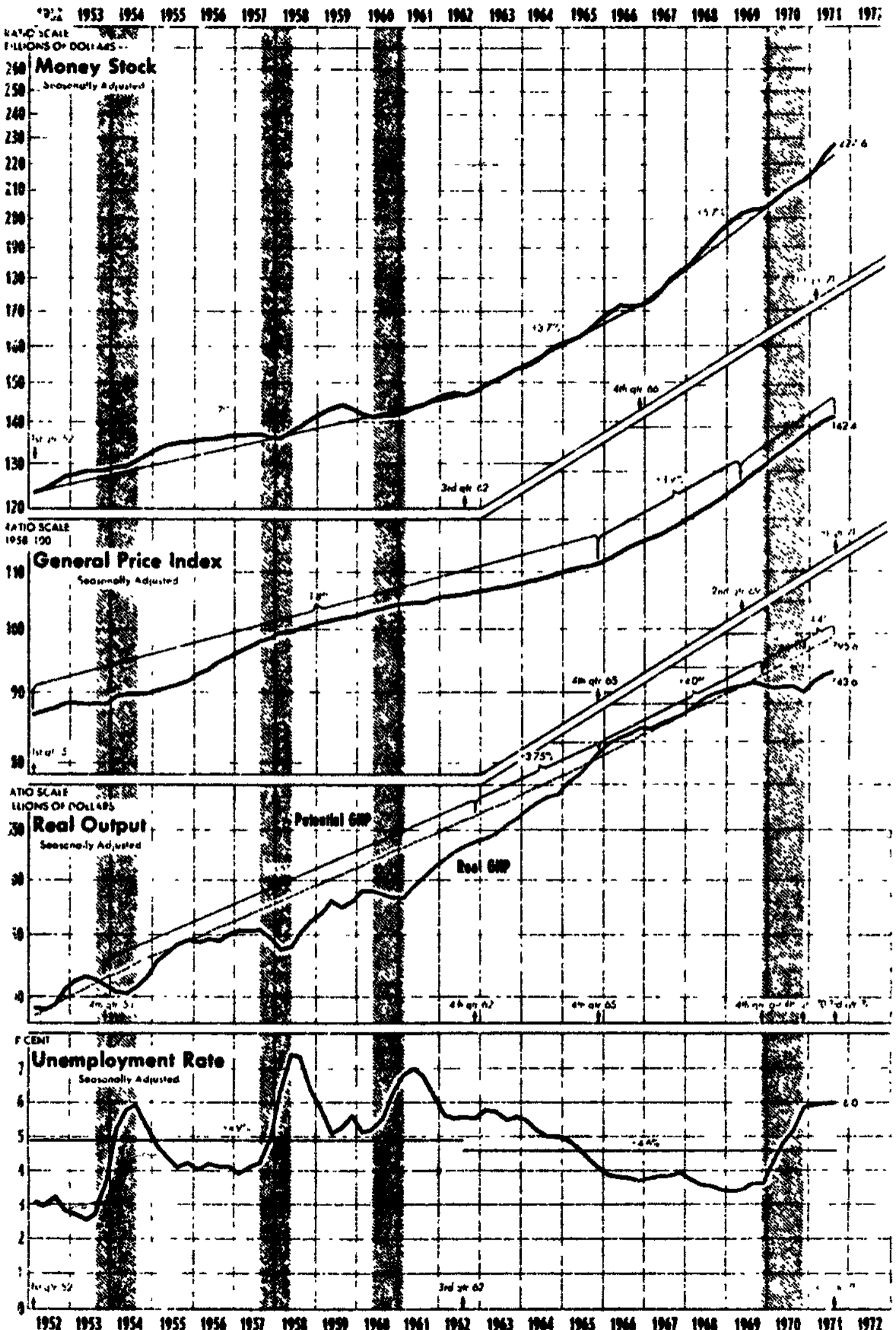
## Basic Causal Force

Let us now turn to the first topic, the basic cause of our serious economic problems. At the Federal Reserve Bank of St. Louis, we have been conducting many studies into economic fluctuations. Considerable evidence has been developed indicating that the economy is basically stable and resilient and not naturally subject to great inflation or recession. Our studies indicate that the course of monetary expansion has been the major destabilizing factor underlying the problems which I have just outlined. According to these studies, the trend growth of money stock, over several years, determines the rate of inflation. Inflation is a monetary phenomena. In addition, variations of a few quarters in the rate of money growth around the trend, as well as a shift in the trend rate of monetary expansion, have an important bearing on movements in output and employment.

Chart I, which was passed out, demonstrates these two propositions and helps to illustrate why we have experienced a high rate of inflation and a high unemployment rate at the same time. This paradox has led many commentators and economists to conclude that the character of our economy has been so changed in recent years as to render traditional economic stabilization tools useless, and has caused these individuals to look for additional tools to curb inflation.

As you can see, Chart I covers the period since early 1952 and contains four panels. The top panel presents the money stock, which consists of demand deposits and currency held by the nonbank public. The second panel is

CHART I



Shaded areas represent periods of business recessions as defined by the National Bureau of Economic Research (latest data plotted).

Prepared by Federal Reserve Bank of St. Louis

labeled "The General Price Index," the broadest measure of price movements available. The third panel is labeled "Real Output." This is total output of goods and services in our economy, measured by Gross National Product in constant dollars. And the bottom panel contains the unemployment rate, that is, unemployment as percent of the labor force. Also on the charts, you will observe four shaded vertical bars. Each of these shaded bars indicates a period of economic recession, as determined by the National Bureau of Economic Research. It is the period from the peak to the trough of the business cycle.

First, let us focus our attention on the top panel. I have divided the period since early 1952 into three subperiods and have shown the trends of money stock for each. The money stock grew at a 1.7 per cent annual rate from the first quarter of 1952 to the third quarter of 1962. Then, the trend rate of growth was accelerated to a 3.7 per cent annual rate to the fourth quarter of 1966. Then, it was further accelerated to a 5.7 per cent annual rate to the first quarter of 1971.

Now, observe that on the General Price Index panel I have also placed three trend rates. We had a period of relative price stability from the first quarter of 1952 to the fourth quarter of 1965. During this period, prices rose at a very moderate 1.8 per cent trend rate, with only one outburst of a rapid price rise, in 1955 and 1956.

Following the acceleration of the trend growth rate of money, prices rose at a 3.9 per cent annual rate from the fourth quarter of 1965 to mid-1969. Since mid-1969 the prices have risen at a 5.1 per cent annual rate. While this is not conclusive evidence that a change in the trend growth rate of money causes a change in the trend growth rate of inflation, it is quite consistent with that view.

This chart also illustrates my second point, that short-run variations in the growth rate of money have an important bearing on output and employment. On the third panel labeled "Real Output", I have placed the trend growth rates of potential real Gross National Product. This shows the practical maximum growth of output given the growth in the labor force, technology, capital resources, and natural resources. The President's Council of Economic Advisors has estimated that the potential GNP rose at a 3.5 per cent rate from the fourth quarter of 1953 to the fourth quarter of 1962, 3.75 per cent rate to the fourth quarter of 1965, a 4 per cent rate to the fourth quarter of 1969, a 4.3 per cent rate to late 1970, and since then at a 4.4 per cent rate.

Now, referring back to the top panel, each of our recessionary periods (shaded areas) was preceded by a downward swing in the money stock relative to the trend. The recessions occurred in 1953-54, 1957-58, 1960-61, and 1969-70. Two minor slowdowns, not classed as recessions, occurred in 1962-63 and 1966-67, following similar downward movements in money. If you focus on the real output panel, it becomes quite evident that whenever the money stock moved back towards the trend rate of growth, that output fell. This happened in each of the four recessions presented on this chart. And, of course, as we moved into each recession, the rate of unemployment rose, as shown in the lower panel.

Another basic proposition is that the economy will naturally grow at its productive potential, if not shocked by money stock variations. You will observe on panel three that after each of the four recessions growth of real output moves back up toward potential output. After the 1960-61 recession the movement back toward capacity output was relatively slow, but this period followed two recessions only two years apart. Also, the economy received a minor additional shock two years later, in 1962, when money declined relative to the trend.

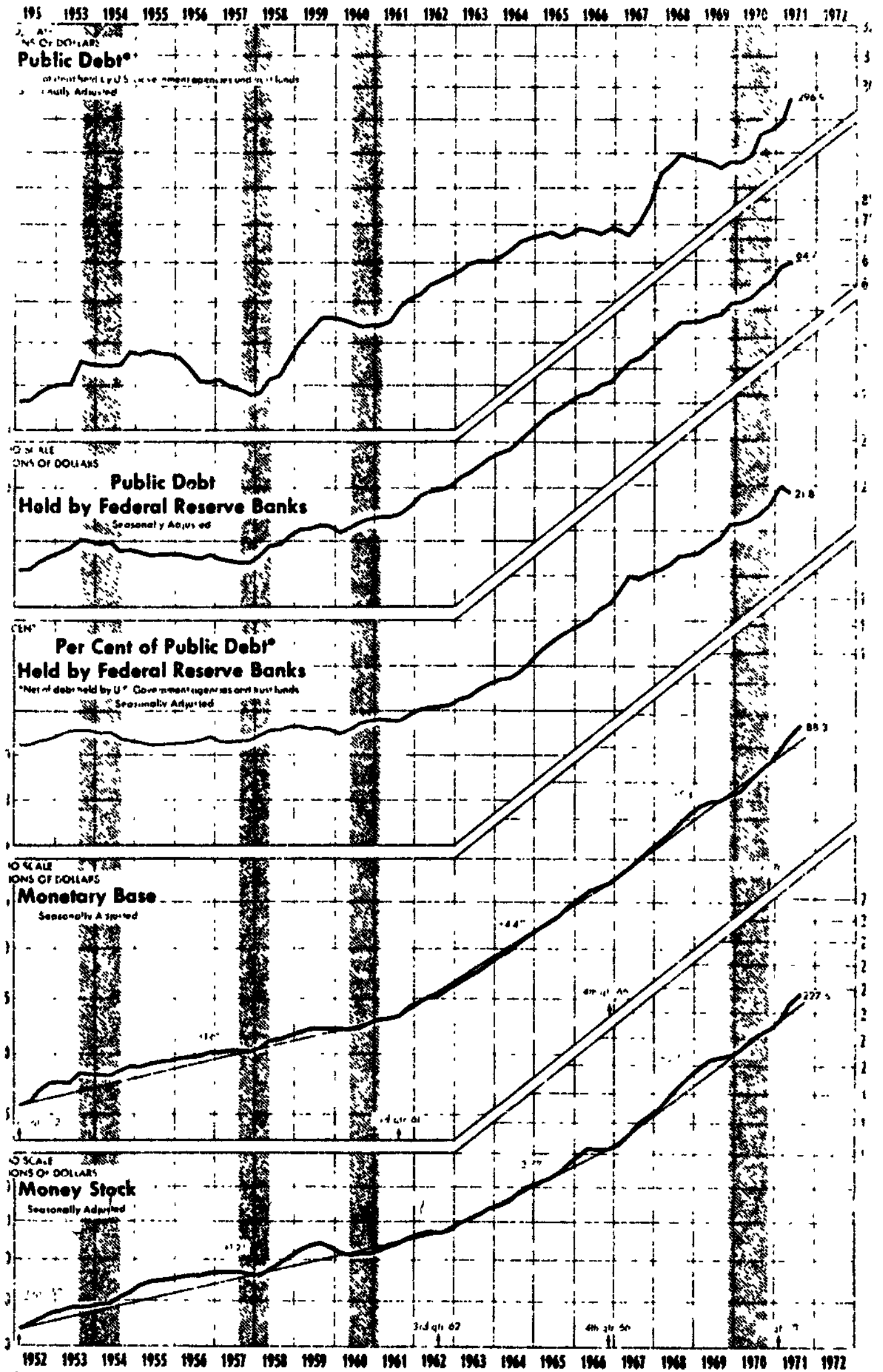
On the unemployment rate panel, you will find that despite slow money growth in the 1950's and early 1960's and very rapid, accelerating, money growth throughout much of the 1960's that the unemployment rate averaged about the same, 4.9 per cent in the first period and 4.6 per cent in the last period. Despite all the fine-tuning we had in the 1960's plus the stimulation received from an accelerating inflation, the average level of the unemployment rate was little affected.

What caused this pattern of monetary expansion over the last two decades, which has had an important bearing on inflation and on output and employment? There are three chief causes, and I will discuss each. First, is the method of financing the rising Government debt, second is concern over interest rates, and third is concern over unemployment.

Let us now look at Chart II, which has five panels. The top panel labeled "Public Debt" is the Federal Government debt outstanding, net of the debt held by U.S. Government agencies and trust funds. The second panel is the "Public Debt Held by Federal Reserve Banks." This is the debt which the System acquires in the course of our Open Market operations. The third panel is the portion of Public Debt Held by Federal Reserve Banks. The fourth panel contains the "Monetary Base" which is the major determinant of movements in the money stock, and the bottom panel replicates the movements of the money stock that you have seen in the first chart.

Let us look now at the role of the method of financing Federal Government debt and the course of monetary expansion. In the early 1950's we find that the public debt outstanding changed little, varying between \$215 and \$230 billion. It began to rise rapidly in the late 1950's and continued to rise throughout the 1960's and early 1970's. At the time of relative stability in the national debt, the Federal Reserve did not change appreciably its holdings of U.S. Government securities. In the late 1950's the Federal Reserve began to add an ever increasing amount of Federal debt to its portfolio. In fact, the rate of acquisition of debt by the Federal Reserve System was more rapid than the expansion of the national debt itself. This is illustrated in the third panel, which shows the share of public debt held by the Federal Reserve Banks. This ratio held nearly constant at around 11 per cent, up to the late 1950's. Since then it has been constantly rising, reaching about 22 per cent at the present.

Movement in the monetary base parallel this acquisition of Federal Reserve debt. When the Federal Reserve buys Government securities, it adds to the monetary base. As I mentioned earlier, the monetary base is the major determinant of the money stock. With these greater purchases of Government



Shaded areas represent periods of business recessions as defined by the National Bureau of Economic Research.  
 \*Data plotted public debt (1971) money stock monetary base (1971)

securities, there has been an acceleration in the trend growth of the monetary base over the last two decades, from at a 1.6 per cent annual rate from early 1952 to the fall of 1961, then to a 4.4 per cent rate to the end of 1966, and since then to a 5.4 per cent rate. You will also observe that a trend growth in money changed in a roughly parallel fashion as the trend growth for the monetary base. So what we had in the 1960's was rising Government expenditures, both for the Vietnam War and for expanding welfare programs. A decision was made to not finance these outlays fully by taxes, but by borrowing. And the borrowing was carried on in such a manner as to be monetized, having the same effect as if the Government had printed money to buy goods and services.

The second factor causing monetary expansion has been a great concern that interest rates should not be allowed to rise very rapidly. This concern was very evident in the last half of the 1960's as certain activities were curtailed because of higher costs of funds. More recently, there has been fear that higher rates would choke-off a "fragile recovery."

This attitude was expressed in the middle 1960's by the Interest Rate Control Act passed by Congress, which literally was a request to the Federal Reserve to lower interest rates, or at least not to let interest rates rise any further. As a result of the concern for rising interest rates, when the Government was financing large deficits and when the economy was expanding vigorously and there were great demands for credit on the part of the private sector, the Federal Reserve bought more and more Government securities in an attempt to hold back the interest rate increases.

The heavy Government borrowing, combined with a reluctance to permit rises in interest rates, accounts, I believe, for the accelerating trend movements in the money stock. What can account for the variability around the trend movements in the money stock? I believe this can be attributed in considerable measure to alternating concern over unemployment and inflation. Whenever the System sought to resist inflation vigorously the growth rate of the money stock was markedly slowed for a short period of time. As we saw in Chart I whenever the growth rate of the money stock slowed relative to the trend, we entered into a period of economic slowdown and the unemployment rate would rise. Then, whenever the unemployment rate rose, the monetary authorities shifted objectives and became much more expansive in order to bring the unemployment rate down. This happened several times throughout the 1950's and 1960's, and each time we had a ratcheting-up of the trend growth rate of the money stock. These expansive actions also help to explain the rising trend growth of money.

### Controlling Inflation

Now, I will turn to my last topic, which is what do I believe to be the basic requirement for success in controlling inflation? If we are to have a successful program in controlling inflation, the basic cause of inflation must be eliminated by achieving a moderate trend rate of growth in the money stock. The recently announced program for controlling wage and price movements will probably be successful for only a few months unless the basic cause of inflation, which is rapid monetary expansion, is eliminated.

In recent months we have observed a slowing in the growth rate of the money stock. While in the first six or seven months of this year the nation's money stock rose at a 10 to 11 per cent annual rate, in the past three or four months the money stock has shown virtually no growth. I view this as a favorable development towards the achievement of a reduction in the rate of inflation. However, the same impediments to the maintenance of a moderate growth rate of money exist now that existed in earlier periods; that is, Government borrowing remains large, concern is great over the level of interest rates, and unemployment is relatively high.

The first mentioned impediment--rising Government debt--is most likely to be a factor influencing money supply growth in 1972. At the present time, most forecasters project a deficit, on a national income accounts basis, in the neighborhood of \$25 billion for calendar year 1972. This is about \$5 billion higher than the estimated deficit for calendar year 1971. If the ratio of Federal Reserve holdings of Government debt to the total outstanding remains constant at 22 per cent, the latest figure, such a deficit could result in a sizeable increase in the money stock.

Let us now look at the interest rate impediment, which could result in an increase in the ratio from its present 22 per cent level. There is considerable pressure to prevent increases in interest rates. Interest rates could be controlled in two ways. One, there could be ceilings fixed by law, as in the case of usury laws, or by regulation of some administrative body. The second way would be for actions of the Federal Reserve to prevent temporarily interest rate increases by permitting more rapid monetary expansion.

It is likely that imposition of interest rate controls would create an impediment to the maintenance of moderate monetary growth. Whenever you fix a price, problems of allocating scarce resources among competitive uses arise. Assuming interest rate controls were effective, demand for funds, in response to rising economic activity, would outpace the supply at the ceiling rates. If rate adjustments were not permitted, the need for rationing would arise. Because of problems of allocating the limited funds among competitive uses and of enforcing interest rate controls, pressures would mount for the Federal Reserve System to expand the total volume of credit. But, if the business recovery is as strong as generally expected and if the Federal Reserve supplies the funds which people demand at the controlled interest rate levels, the System would have to acquire an increasing proportion of Government debt outstanding. As happened in the last decade, the trend rate of money growth would increase and inflation would be intensified.

The outlook for market forces on interest rates during the balance of 1971 and into 1972 is not clear. On the one hand, there most likely will be downward pressures on rates as expectations of inflation are revised downward. On the other hand, large Government deficits and expanding economic activity are expected to place upward pressures on interest rates. In view of the uncertainty as to the direction and extent of net market pressures on rates, it would seem best that rates of interest be allowed to find their own levels.



in the market. If the System contracts money to avoid a decline in interest rates, a recession may develop. If the System expands money rapidly to avoid higher interest rates, additional inflationary pressure will develop.

Let us now take up the unemployment impediment, which results from the public having unrealistic aspirations with regard to the unemployment rate. Much of the unemployment is structural, caused by monopolistic practices of unions and businesses, by Government regulations, and by limited information available about the job market. Unemployment that is a result of cyclical forces has usually tended to recede slowing in periods of recovery as producers try to avoid ratcheting costs up until they are relatively certain of recovery. Yet, aspirations of attaining high employment quickly place great pressure on monetary authorities to engage in rapid monetary expansion. But if this should happen, we would again find the demand for goods and services pressing on supply and price pressure would build up, and as a result there would be a very severe test of any sort of a price and wage control system.

### Conclusions

In conclusion, I would like to make two points:

First, monetary actions have been the cause of both inflation and high unemployment. They are the cause of inflation when we have an excessive growth trend of the money stock. They are the cause of high unemployment when we have excessive variations in the growth of money around the trend.

Second, experience over the last two decades indicates that inflation will not be brought under control until the trend rate of monetary expansion is reduced to the trend growth rate in the amount of money people desire to hold at stable prices--probably about 4 per cent a year. This experience also indicates that attempts at fine-tuning of the American economy have caused more problems than have been solved and should be abandoned, particularly with regard to monetary actions which take effect with a time lag. Furthermore, it would be best if we adopted a fairly constant non-inflationary growth rate of the money stock. Doing so would prevent the fluctuations in money growth which have been the chief factor causing production and employment to fall from their potential levels.

I conclude that success in the fight against inflation over the next few years will depend greatly on what the monetary authorities do with regard to the growth rate of money. If we get a lower growth rate of money and steadily maintain this lower growth rate, then we should see many of the problems which have led to disarray in our economy, and the world economy, disappear from the scene.