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FEDERAL RESERVE BANK OF ST. LOUIS**

**BEFORE THE COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS**

UNITED STATES SENATE

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Statement of Darryl R. Francis

Mr. Chairman and Members of the Committee:

I am pleased and honored to have this opportunity to present my views on your resolution regarding the conduct of monetary policy and the pursuit of stable monetary growth. Let me state at the outset that I am wholeheartedly in favor of achieving and maintaining a stable rate of growth of the nation's money supply in order to minimize economic fluctuations. I have stated many times in public remarks that there have been, in my judgement, serious errors in the conduct of monetary policy which have increased economic uncertainty, contributed to a mounting inflation, and, at times, worsened the situation in terms of real production and employment in the economy.

Nevertheless, I must express some reservations about giving an unqualified endorsement to the proposed concurrent resolution. A resolution to achieve a reasonable, noninflationary growth of the nation's money supply could have a positive effect on the economy. However, the precedent involved in Congressional participation in the setting of target growth rates of the money supply, especially for short periods, could contribute to an even worse situation than we have experienced in the past. I will elaborate on my concern for the potential misuse of the good intentions implied in your resolution.

I think it is absolutely essential that the members of Congress fully understand that a policy of maintaining a stable, noninflationary growth of the money supply has implications for

the ability of the government to finance deficits and stabilize interest rates. My views on these matters crucially affect my analysis of why we have had considerable variation in money growth and an accelerating trend of money growth; and bear directly on my comments on the proposed Concurrent Resolution.

I have observed what I consider to be excessive preoccupation with the level of or fluctuations in short-term interest rates on the part of many of those concerned with economic stabilization. This concern has contributed to a short-run focus in monetary policy deliberations which has resulted in a pro-cyclical tendency in the formulation and execution of monetary policy. I would argue that actions of past Administrations and Congress with regard to government expenditures, as well as the views of individual members of Congress with regard to interest rates, have contributed significantly to the errors in monetary policy during my participation in Open Market Committee deliberations.

I want to take a few moments to spell out my views on the relationship between market interest rates and the growth of the money supply. It is extremely important for the general public as well as members of Congress to understand that changes in the growth of the money supply affect market interest rates in the short run in a manner which is opposite to the impact in the long run. It is recognized that when the Federal Reserve buys government securities, interest rates fall. In general, this is true only in the short run. The other part of the story is equally important.

When the Federal Reserve buys securities on the open market, bank reserves are increased and consequently the money supply expands. As growth of the money supply increases, the demand for goods and services, with a lag, also grows more rapidly; ultimately, credit demands in the private sector of the economy expand as the recovery progresses. The larger are any government deficits that occur at the same time, the greater will be the overall increase in the demand for credit and the greater will be the short-run upward pressure on interest rates. As the combined pressures of government deficits and growing private credit demands begin to offset the initial downward effects of a more expansionary Federal Reserve policy, interest rates will rise. Any increased efforts on the part of the Federal Reserve to resist this short-run upward pressure on interest rates will result in further acceleration in the growth of bank reserves and the money supply. Once begun, the process becomes a treadmill when the inevitable inflation resulting from excessive money growth is set in motion.

When interest rates are at historically high levels, it does not mean that monetary policy has been tight. Rather, high interest rates are a symptom of an earlier excessively rapid growth in the money supply which has generated inflation. Basing monetary policy recommendations on the immediate impact of Federal Reserve purchases in the open-market and ignoring the longer-run results has been, in my opinion, the main cause of the undesirable pattern of money supply growth observed in the past. The point is that interest rates are simply a price --

the price of credit -- and when a faster growth of the money supply means higher prices for food and clothing, it also means a higher price for credit. The way that the Federal Reserve can contribute to achieving a lower level of interest rates is to maintain a reasonably slow and steady growth of the money supply.

In the past, the occurrence of government deficits has placed upward pressure on market interest rates. Usually, members of Congress have expressed concern that the Federal Reserve was not doing enough to maintain low interest rates. Now, once again, we are facing massive government deficits which will put upward pressures on interest rates. This brings me to my greatest reservation with regard to your resolution, which lies in the interpretation of the fourth paragraph. I will read it and elaborate:

(quote) Whereas the substantial budget deficits anticipated during fiscal years 1975 and 1976 could result in substantially higher interest rates and a reduced supply of mortgage credit in the absence of reasonable growth in the money supply . . . (end quote)

(emphasis added)

It appears to me that this paragraph could easily be interpreted to define indirectly the desired growth of the money supply, and I am concerned that such growth could be excessive. Let me be specific.

The paragraph says interest rates will rise "in the absence of reasonable growth in the money supply". If this is taken to mean that the growth of the money supply should be

sufficiently rapid so as to prevent any increases in market interest rates, then prospects for a steady noninflationary growth path for money are doomed to failure.

Even though we have recently observed markedly declining short-term interest rates, brought on by weak aggregate demand and declining credit demand, I fear that as we move past the middle of this year, the massive federal government deficits, together with the substantial borrowing by federal government agencies and state and local governments, and combined with a strengthening private economy, will produce rising short-term market interest rates as the growth of the demand for credit begins to exceed the growth of the supply. I can foresee this happening even while the rate of unemployment is still at unacceptably high levels. What worries me is that there could be, once again, considerable pressure from members of Congress to resist this tendency for interest rates to rise so long as unemployment is still high. If such pressure is brought to bear on the Federal Reserve System and its Open Market Committee, and actions are taken to hold down interest rates or slow their increase, then bank reserves and the money supply could once again expand at excessively rapid rates.

Any efforts to prevent increases in market interest rates associated with the large government borrowing would mean that interest rate increases would be delayed -- but they

would be just as certain. The peaks would come later -- but they would be higher. The housing industry would be less severely impacted in the short-run -- but its recovery would be short-lived. It is not my custom to be a disciple of doom, usually I am very optimistic with regard to the U.S. economic and political system. But at the present time, I am more discouraged than ever before.

Last summer I testified before the House Committee on Banking and Currency that the rapid rate of monetary growth in the past few years has caused an excessive rate of expansion of total spending in the economy which has been the underlying cause of the inflation we are still experiencing. There is no doubt in my mind that inflation is basically a monetary phenomenon. Thus, a reduction in the trend rate of growth of the money supply is absolutely essential to ultimately purging inflation from the economy, and I agree with the resolution's recommendation that, in the long run, money supply growth should be commensurate with the economy's potential to increase output.

However, the abrupt deceleration in monetary growth that has occurred since the middle of last year was greater than I would have recommended, and I would not recommend that monetary growth as low as that which prevailed over the past half year be continued through 1975. Consequently, I agree with your resolution that some increase in the rate of monetary growth is desirable at the present time. But I am also concerned that monetary attempts

to reverse the decline in real output and employment may be pursued so vigorously as to set the stage for a new round of accelerating inflation.

It seems likely to me that esteemed members of the economics profession might persuade Congress or the Federal Reserve that "reasonable growth of the money supply", under the present circumstances, is far in excess of what I consider to be desirable. I am aware that there are a number of leading economists and economic advisory organizations that have been urging a growth of the money supply this year of 8 or 10 percent, or possibly even more. Let me state unequivocally that I could not disagree more emphatically. We dare not maintain a high rate of monetary growth until we see "the whites of the eyes" of re-emerging inflation -- by then it will be too late. We have been down that road before, and I fear that we will tread that path once again.

Let me take a few moments to give you my interpretation of what happened to the economy last year so that you can better understand my resistance to the idea of using large doses of monetary stimulus to bring about rapid recovery. The current recession which gave off its first signal by a slowing in production beginning in the first quarter of 1973, is very unique in the respect that monetary actions were not among its initial causes. It is one of the very few economic contractions that has not been foreshadowed by a significant move towards monetary restraint, and it cannot be quickly cured by a massive move to monetary ease.

As I have already stated, I believe that monetary growth was much too expansive over the past few years, at least up until the middle of 1973. The accelerating growth of the money supply led to excessive growth of aggregate demand which aggravated the stresses on the economy at a time when a series of shocks took place.

The further decline in economic activity experienced since late 1973 is the result of several complementary, autonomous events which reduced the productive capacity of the economy and induced significant shifts in demand for resources within the economic system. The growth of real output was certainly reduced in 1974, but not primarily as a consequence of deflationary monetary actions, although at the present time the downturn most likely has been exacerbated by the slowing of money growth noted earlier in my remarks. Rather, the reduction in the growth of real output was the result of distortions which severely limited our real economic potential.

Included in the list of shocks are the oil embargo and the subsequent quadrupling of imported petroleum prices; the imposition and subsequent elimination of wage and price controls; the implementation of new environmental programs; mandatory resource allocation efforts; the bad crop harvests both here and abroad; and the impact of the occupational and product safety legislation. For example, in the case of energy, the sudden and unexpected move by oil exporting countries to make effective their monopoly position has increased significantly the costs of production in many industries.

Some of these factors, such as the environmental and safety programs, have beneficial consequences, but their economic costs cannot be overlooked. The automotive and related industries which bore much of the initial impact are a good example. The legislated shift to safer and less polluting automobiles, in combination with environmental and safety restrictions on the manufacturers, has greatly decreased the quantity demanded. The recent increase in gasoline prices and the real threat of fuel allocation or tax programs have further depressed demand.

Given the magnitude of these shocks to this industry alone, a significant set-back to aggregate production was to be expected. There is little that monetary stimulus can do to correct this type of problem. Substantial increases in aggregate demand would only magnify our present problems. The economy is going through a necessary period of adjustment to these changes. This adjustment, given existing laws and regulations, will probably take considerable time.

Consequently, I believe that the risk is indeed very great that the well-intentioned efforts to improve the economic situation in the short run by expanding money at too rapid a pace could create a nightmare situation in two or three years.

Finally, let me turn to the recommendation for semi-annual hearings on money supply growth targets. Generally, I am in favor of increased disclosure of Federal Open Market Committee deliberations and decisions, and am favorably inclined towards the semi-annual hearings if they serve that

purpose. The Federal Open Market Committee has moved in the direction of greater disclosure of the specifications employed in implementing monetary policy. And I believe that more steps can, and should, be taken in that direction. I believe that it is desirable to provide both Congress and the public with more information about monetary matters in order to reduce the uncertainty involved in making economic decisions that are affected by monetary policy actions.

I see nothing wrong with holding hearings to evaluate the Federal Reserve's efforts in achieving its target at six-month intervals, but I would urge against revising the long-run target in such short intervals. It has been my long held belief that it has been undesirable for the Federal Open Market Committee to alter considerably its long-run growth targets for money at intervals as short as six months, and it would be just as undesirable for Congress to direct it to do so.

In closing, I wish to say that I am much encouraged with our agreement that over the long-run the money supply should grow at a rate not to exceed the trend growth of potential output -- about 4 percent. But I would like to point out that such growth, while providing long-term stability, can be sustained only if short run changes in relative prices, including interest rates, are permitted to take place. In the past, and in the present, public concern for the fortunes of specific industries or specific sectors of the economy have

created pressures which culminated in attempts to stabilize relative prices at the expense of the stable growth of the economy as a whole. These pressures on the Federal Open Market Committee have resulted in the actions that produced the variable growth in the money supply.

I am afraid that these pressures will soon be with us again. While I agree that the rate of growth of money supply has been too slow for the past seven months, an acceleration designed to hold interest rates at an artificially low level would make mockery of your goal of stability in money growth and stability in economic growth.

I agree that there should be frequent disclosure of FOMC decisions. A periodic joint review of monetary actions by Congress and the Federal Reserve might contribute to better policies. However, I do not believe it would be desirable to hold hearings for the purpose of deciding in advance the specific monetary targets that are to be pursued.

We are all in agreement on striving for maximum, non-inflationary growth of the economy. We are also in favor of lower interest rates and avoiding high levels of unemployment. Full recognition of what the Federal Reserve can do, as well as what it cannot do, to achieve these objectives is essential for the type of monetary policy we all want. The Federal Reserve must have the support of Congress in achieving a stable growth of the money supply. I hope these hearings indicate that Congress is willing to give the Federal Reserve that support.