



ARE CONTROLS NECESSARY?

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A little less than one year ago, I was appointed President of the Federal Reserve Bank of St. Louis. In that position, in addition to serving as chief executive officer of an organization of some 1500 individuals who perform central banking functions in a 7-state area, it is my responsibility to represent the Eighth Federal Reserve District in monetary decisions which have a major impact on the economy of the the United States.

This responsibility is an especially challenging one at this time in view of the current status of the economy. We have recently experienced our most severe recession since World War II. Inflation, which two years ago reached double-digit proportions, is still a matter of serious concern. We are at present in a phase of the economic cycle which some interpret as a pause in the recovery and others see as a prelude to further recession.

Unquestionably, the next few months will bring decisions which will have a profound effect on our longer-range economic future. If those decisions are wise ones, we will all benefit. Conversely, if we misjudge where we are and embark on irresponsible policies, we will all suffer.

Fundamental to the development of sound economic policies is our ability to accurately judge the current state of the economy. Is what we are presently experiencing in fact a pause in the recovery? Or is there real evidence of a return to recession? In my opinion, there is no real evidence at this time to lead to a belief that we are headed into a period of renewed recession.

On what do I base this judgment? Primarily on a realistic evaluation of the data which is most frequently used to judge economic trends.

Let's look at three economic indicators most frequently quoted as economic barometers: GNP, housing and unemployment.

It is true that real gross national product which grew at a rate of 7.3% in the 12 months following the low-point of the recession has now slowed to a growth rate of 3.8%. What about a 3.8% growth rate in GNP? Over the past 30 years, real GNP has grown at an average annual rate of 3.5%. To be sure, there have been periods when GNP grew faster, and periods when it grew slower or even declined; but it has tended normally to return to the 3.5% average rate. Since the most recent recession produced a 5.3% decline in GNP, it is certainly not surprising that for a period of months after the recession reached

its lowest level, the rebound in the recovery was very rapid. But as the recovery continues, it is also not surprising that the growth rate is trending once again toward its average of 3.5%. There is no way that increased spending at this time can permanently increase the normal rate of economic expansion without causing serious inflation and there is no way that this recovery can be expected to continue at its initial speed. Thus the slow-down in growth of GNP that is now so widely viewed with alarm was to be expected and cannot be suddenly reversed without huge costs in future inflation.

Others see housing starts as a sign of economic distress. In 1972 total private housing starts amounted to 2.4 million units while as of October of this year there were only 1.8 million under way. What to do about it? They would: "lower down payments and interest rates and if private savers are not willing to offer their savings at these rates of return, then stimulate lending through government subsidies."

It is true that starts are lower than they were in 1972 and 1973. Yet the recovery rate is very much as should be expected. Housing starts in all post-war recoveries increased on average at a 51% rate during the first 19 months of the recoveries, and are currently increasing at 83% over the same time span through October of this year. The October rate is still the highest monthly rate in the past 2-½ years.

Another oft-quoted number that induces calls for economic stimulus is the unemployment rate. And, indeed, the present rate of 7.9% is high by historical standards. When the Full Employment Act was passed in 1946, 4% was considered "normal" and today some people would like us to think that anything above 4% means that people are being laid off their jobs, deprived of the means of supporting themselves and their families and, thus, are being subjected to severe hardship.

Now job loss and involuntary layoffs. . .the kind of situation that is usually associated with recessions. . .are among the causes of unemployment. But there are other very important causes. In recent years millions of people, including large numbers of women and teenagers, who formerly were not interested in work are now seeking employment. In the past 10 years, during a period when population increased by 19%, the labor force has increased 26%. Thus, even if no one had been laid off, the unemployment rate would have increased merely because more people stated they were looking for work. In fact, in the second quarter of 1976 we had the highest percentage of our population

employed since 1946 and at the same time one of the highest rates of unemployment in recent history.

Furthermore, unemployment insurance in many states provides for such relatively high rates of compensation for such long periods of time that the incentive to seek a job often is lacking. I assume that many of you saw the segment of CBS 60 Minutes' show which showed unemployed workers from Michigan vacationing in Florida and drawing unemployment compensation while they were enjoying a very pleasant sojourn in the sun.

What this all indicates to me is that the present unemployment rate is not necessarily a reflection of a serious slowdown in the economy. While I do not deny that we should try to find employment for anyone who wants to work and that their work would contribute to the total product of our economy, I have my doubts whether the present situation justifies massive governmental action or that governmental action could even do much in the short run to remedy it. In my judgment, the 7.9% unemployment rate should not be interpreted as a valid indicator of a serious economic slowdown.

What this all adds up to is that the economy is not in as bad a shape as some claim it to be. Even though the speed of the recovery during the past several months is less than might have been hoped for, there are no signs that the recovery will not persist. In my judgment, the scare stories that we hear today are not based on an accurate interpretation of actual conditions, but stem from value judgments of what the economy should be doing, irrespective of all the historical evidence of what it can do.

Even more disturbing than misinterpretation of economic trends is how those who advocate a faster growth rate, or lower unemployment rate or more and better housing, want to go about getting the job done. Some economists, when they find the achievement of their goals to be not easily attainable by market forces, call for government action to stimulate private spending or to redistribute income to those sectors of society which they feel they want to support. When inflation results, they then call for wage and price controls.

In the limited time available this evening, I shall not deal with proposals for fiscal or monetary stimulus other than to say that I do not believe that current conditions justify such measures. I would, however, like to touch on the subject of wage and price controls.

There has been speculation in recent weeks that the imposition of voluntary wage and price controls is under consideration as a device to hold back inflation while the economy is stimulated by fiscal or monetary measures. Voluntary or mandatory, there is very little evidence that wage and price controls could accomplish such a purpose. Controls have not worked in the past; there is no reason to believe they would now. They certainly are no deterrent to inflationary pressures and in the long run can be counted on to result in higher rates of inflation.

Rather than solve economic problems, wage and price controls create them. They cause shortages of goods and services, reductions in capital investment and misallocations of economic resources. They lead to loss of jobs and intensify inflationary pressures, thus frustrating the very goals they are designed to achieve.

Economic systems, be they capitalist, communist, socialist or whatever, face the same problems - what to produce, how to produce it, and for whom to produce. A market economy such as ours attacks these problems through economic freedom — allowing each individual to determine his own priorities and direct his resources in ways that promise to yield the maximum amount of individual satisfaction.

An essential element of our system is the price and wage mechanism, which serves to direct productive effort into the areas where the public has indicated a desire to consume. Prices and wages serve to allocate resources between markets. In periods of wage and price controls, this mechanism is destroyed and the ability of the economy to allocate its resources efficiently is lost.

History is replete with examples of the failure of controls. We don't have to go back to the black marketeering, price chiseling and rationing of World War II to prove our point. Let's look instead at the period after 1971 when wage and price controls were most recently imposed.

In the spring of 1973, the government imposed controls on the price of certain agricultural products, including beef. Now agricultural prices are normally set in free markets by the interaction of supply and demand. Producers make supply decisions in anticipation of future profits.

When price ceilings were imposed on beef in 1973, producers were suddenly confronted with a reduced prospect for profits while their potential for loss remained unchanged. The result was a disincentive to produce, and this, of course, led to a reduction of available supply and an even higher price to the consumer when controls were removed.

A similar situation prevailed in industrial production. When some prices were artificially depressed below profitable levels, firms either shifted their product mix where possible to items which were more profitable under the circumstances or they reduced the scale of their operations in an attempt to minimize losses. The result was higher prices and increased unemployment as evidenced in the aluminum and scrap steel industries in 1974.

Perhaps the best-known example of the detrimental consequences of price controls is the gas and fuel oil program. In 1974, the price of fuel oil was frozen. Gasoline, a by-product of oil refining, remained uncontrolled. When demand pushed up gasoline prices, oil refineries simply shifted production to more gasoline and less fuel oil. As a result, fuel oil shortages became so severe in some northern states that schools had to be closed while a glut of fuel oil remained unused in other parts of the country. It was cheaper to sit on inventories of fuel oil than to sell at the controlled price!

And at this very moment we find ourselves at the mercy of the OPEC ministers who are meeting in Vienna in contemplation of further oil price increases. Price controls are one reason for our current predicament. You will recall that when the oil embargo was first implemented, price controls were imposed on domestically produced oil in order to blunt the increase in the price of oil products. What was the consequence of that action? The artificially depressed prices did not discourage oil consumption which continued to rise. Controls did discourage domestic oil production which fell precipitously, thus increasing our reliance on oil imports. As a result we are more dependent than ever on foreign sources and the OPEC nations have us over the proverbial barrel to an even greater extent than before.

A further negative element is the depressive effect controls also have on plant expansion and capital investment. When faced with an inability to predict prices and availability of raw materials, businessmen cannot plan for the future with any degree of confidence. Plans for plant expansion and capital improvements are postponed and the result

is a slowdown in economic growth and an increase in the potential for unemployment.

Attempts to circumvent controls encourage producers to seek uncontrolled markets, thus causing shortages in those markets where controls are in effect. An excellent illustration is fertilizer materials which were subjected to price control in 1973. Prior to controls, about 4-½ million short tons of fertilizer were exported annually. By the end of 1973, U.S. producers were exporting between 6 and 7 million tons and severe shortages were avoided in this country only by drawing heavily on inventories which were reduced by almost 40% in the same year. When fertilizer was decontrolled in October 1973, prices skyrocketed as a consequence of the shortages brought about during the prior period of controls.

I repeat, wage and price controls do not work. Instead of preventing inflation, price controls make the situation worse; they ultimately intensify inflation. While they do sometimes tend to mask inflationary pressures, they do nothing to eliminate the root causes of inflation. When prices are not free to move in response to increases in demand, the market has no way to determine where resources can be used most efficiently. Efficiency is reduced, confidence is dampened, the free market is destroyed and inflationary pressures ultimately increase.

As I said before, these are challenging times and the next few months are almost certain to bring forth some interesting economic proposals. We can expect proposals for stepped-up spending by government; there will be calls for monetary stimulus; and very possibly the time-worn proposal for wage and price controls will be dusted off and placed before us again.

As bankers and as citizens with a deep stake in the future of this Nation, it is important that we listen to all proposals and carefully consider all options. It is equally important that we not permit ourselves to be panicked into hasty, ill-advised actions which would lead to a further erosion of free market economic forces which have served our society so well.

History is full of examples of nations that relinquished their freedoms on the false assumption that government can somehow accomplish goals that are unattainable through free markets and free institutions. I know it is sometimes tempting to listen to those who would have us believe that the American experiment is running out of steam and that it is

our inevitable fate to follow in the footsteps of other great societies which lost their way and ultimately declined into oblivion.

I believe in the American system and I believe in the capacity of free individuals to manage their own destinies. If you share in these beliefs, and I know that you do, I urge you to speak out on these important issues and join with me in urging others to be willing to forego the apparent simple solutions of the moment for the long-term benefit of future generations. By doing so, we will serve our own best interests and assure a brighter future for our children and our children's children.