



REMEDIES FOR UNEMPLOYMENT: A QUICK OR A LASTING SOLUTION?

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As business leaders, most of you in this audience have contact with the science of economics. If you are as I was when I joined the Fed a year ago, you probably tend to view economics as a remote realm of charts and graphs and indices. A realm shrouded in mystery.

As a non-economist, I can sympathize with that feeling. It is difficult for a layman to grasp economic issues on the same level as scholars and professionals who have devoted their lives to refining their understanding of the field.

But, really, economics is not so very mysterious, and certainly, it is not at all remote. Economic issues touch each of our lives every day in many ways. And, on occasion, some economic issues impinge upon our personal lives with jarring force.

Unemployment is such an issue. At least for those directly affected, the problem of unemployment is not at all remote. And, of course, you don't have to be unemployed yourself to be deeply concerned about the level of unemployment we now have in this country.

Our current 7.3% unemployment level is intolerable. It places a severe hardship on a significant segment of our population. It underutilizes our economic potential. It is a problem which must be addressed.

What to do about unemployment and how to do it will be the subject of these remarks this afternoon.

There are those who feel that the best way to create more jobs and to reduce unemployment is through stimulation of the economy by the federal government. Various methods are suggested for creating such stimulation, but unfortunately they all have one thing in common: to be effective, they require a significant increase in the growth of the nation's stock of money. And we know that expansion of the money supply at a rate faster than the growth in the nation's output of goods and services results in inflation.

Many advocates of stimulative fiscal and monetary policies recognize the inflationary consequences of such actions. Yet they argue that the urgency of reducing joblessness is worth the risk of increased inflation.

Differing with them are economists and policymakers who feel it is important to avoid approaches to today's unemployment problem that will create inflationary problems tomorrow.

To observers of this debate, it must often appear that we are being asked simply to choose between unemployment and inflation. If that's the choice, many people, naturally, will consider inflation the lesser of two evils and choose to lower the unemployment rate regardless of later inflationary consequences.

But the choice is not simply between inflation and unemployment. The choice is more complicated than that. To understand the two options we face, let's examine each in some detail.

Let's look, first, at the quick solution offered by the advocates of economic stimulation. Their reasoning goes like this. If money supply is expanded, the additional dollars injected into the economy will create additional demand for goods and services. Additional demand, in turn, will encourage additional production. In order to increase production, producers will hire additional workers, and thus, the level of unemployment will drop.

Can this occur without causing inflation?

As long as additional production is accomplished merely by putting into use existing productive capacity that is currently idle, prices will not be affected much. In the short term, it would seem possible to accomplish our goal of lowering unemployment without suffering the damaging side effect of inflation.

But, unfortunately, the effect of economic stimulus created by accelerating money growth, if not sustained, lasts only about a year. After a year, without further stimulus, output growth tends to decline toward its original rate.

Let's introduce some numbers into our scenario to illustrate what we mean. Let's take today's circumstances where we have money supply growing at an annual rate of 5½%, real GNP growing at about 4½% and an unemployment level of 7.3%. Let's say we

begin our attack on unemployment by increasing the rate of growth of our money supply from the current annual rate of 5½% a year to a rate of 7½%. That would cause the growth rate of the economy's output of goods and services (real GNP) to increase this year from its current level of 4½% to an annual rate of about 6%. If that happened, the unemployment level, by the end of this year, could be expected to drop to about 7%.

But that is still a long way from full employment. Today, an unemployment level of 5½% is generally considered to be realistically achievable full employment. There's a significant difference between 7% and 5½%.

As I said, by the end of one year of stimulus, the effect of the initial increase in the rate of money growth would have run its course. The rate of output growth would begin declining back toward the 4½% level. And, the unemployment level would stop declining. If our objective is to reduce the level of unemployment below 7%, the growth rate of the money supply would have to be increased a second time.

This time, let's say we raised the annual rate of money growth from 7½% to 9½%. The second acceleration would stimulate a further increase in demand, which would encourage an additional increase in production, which would lower the unemployment level again. With a 9½% rate of money growth, it is reasonable to expect that a functional full employment level of 5½% could be achieved by about the end of 1978.

Let's call that the "quick approach." There we would be, ready to usher in 1979 with full employment. Our mission would seem to have been accomplished.

But wait! We would have money supply growing at a rate of 9½% a year. We know that a 9½% growth in money supply would bring about a 9% growth rate of inflation in about two years, and obviously 9% inflation is too high. Pressures would arise to do something to correct that situation. Perhaps, once the fast rate of money growth has served its purpose, it could simply be cut back again.

We could do that, of course, but if we did we wouldn't like the results. Just as sharply expanding the rate of money growth temporarily lowers the unemployment rate, a sharp decrease in the rate of money growth would raise the level of unemployment. Thus, in 1979, if we are as concerned with maintaining full employment as we were concerned in 1977 with achieving full employment, we wouldn't be able to do a thing about

the 9½% rate of money growth we would then have. We'd be stuck with it.

And, at that point, the economy would be producing at full capacity. A 9½% rate of money growth with the economy at full capacity would almost certainly result in intolerable inflation. By attacking our present unemployment problem through excessive stimulation of the economy we can reach full employment by 1978, but we will also have a 9-9½% annual rate of inflation by 1980.

Now, let's consider another approach to the problem.

At its present rate, real GNP probably will grow 4½% in 1977. Unless interrupted by some unforeseen catastrophic event, that annual rate of growth may be expected to continue in future years without increased stimulation by the government. Growth at that rate will cause unemployment to drop, but of course, at a slower pace than if output were stimulated.

Functional full employment could be expected to be reached by 1980 without increased fiscal or monetary stimulus. And, since the rate of money growth would not have been increased, in 1980 we could expect that inflation would be growing at approximately the same 5% rate that we have today.

Thus, we would be rewarded with full employment and a much lower rate of inflation than if we followed the "quick approach."

So, the choice we must make is not merely inflation or unemployment. Rather, the choice is between a 1980 in which we would have full employment with damaging inflation and a 1980 in which we would have full employment with an inflation rate no higher than the current rate. The question we must answer in 1977 is not, do we prefer unemployment to inflation? Instead, the question we must answer is, do we want to trade a faster return to full employment for a prolonged higher rate of inflation.

To achieve permanent full employment by 1978, we must be prepared for a prolonged period of intolerably high inflation. On the other hand, if we are willing to wait until 1980 to reach full employment, we can accomplish our goal with substantially less inflation.

Now, this is not an easy decision. Some people feel we must return to full employment as quickly as possible regardless of the inflationary consequences. After all, they argue, unemployment is not just numbers. Unemployment is people whose lives have been disrupted, people who need help now. They might even say, "He preacheth patience that never knew pain."

But let's consider the effect of a 9% rate of inflation on future unemployment, the very problem we are trying to remedy. I submit that 9% inflation would frustrate any prospects for maintaining full employment once it is achieved.

I base this assumption on the premise that monetary policy can only briefly affect the growth of output and, thus, the unemployment level. That in the long run, trends in output growth and unemployment are dominated by fundamental forces in the economy.

Two such fundamental forces directly affect job availability. They are capital investment and development of technology. Without capital investment and new technology, job opportunities cannot expand. In a free economy, decisions to invest resources in the development of new technology and new plant and equipment are based on the anticipation that new productive capacity thus created will enable the investor to earn a reasonable return on his investment.

Inflation tends to diminish the incentive for capital investment. If a real rate of return of 3%, for example, will satisfy the investor and he believes the rate of inflation is going to stay at 5%, then he knows he must plan to realize a nominal rate of return of 8% on his capital investment. If he believes the rate of inflation is going to jump to 9%, then he must plan to realize a nominal rate of return of 12%.

The investor's confidence in the inflation forecast has a direct bearing on his decision to invest capital. If he believes the rate of inflation is going to increase from 5% to 9%, he is likely to say to himself, "Suppose those darn economists are wrong again. Suppose inflation goes to 12% rather than just to 9%. Then I'll be in real trouble."

Beset with such uncertainty, the investor is likely to wait for conditions that seem to him to be more stable.

Changes in the rate of inflation breed uncertainty and uncertainty discourages investment. As the rate of investment declines, the rate at which new jobs are created also tends to decline. The economy becomes less able to absorb new workers and the permanent or "normal" unemployment level rises.

So, those who say we must solve today's unemployment problems as quickly as possible, regardless of any inflation we may create thereby in the future, are totally ignoring the probability that such action would probably increase rather than decrease unemployment.

The quick solution is not the more compassionate solution. It merely seeks temporary relief at the expense of future problems.

Our goal should not be a quick dramatic, but temporary, drop in the level of unemployment. Our goal should be to minimize unemployment for years to come.

If we are to approach the unemployment problem with compassion, we should not strive merely to alleviate the current pain, we should strive to eliminate the disease.

That, it seems to me, is by far the better way to deal with the problem of unemployment. It is in some respects a more difficult course of action because it requires us to act deliberately, or even to simply wait, at a time when our deep concern makes us very anxious to act quickly and forcefully. But it offers more permanent relief and, thus, is the solution that can be counted on with the most certainty to improve the lot of those who are most directly affected.