MONETARY POLICY: THE CHOICES AHEAD

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I am pleased to appear here to discuss some of our Nation's economic problems. I know that you, as savings and loan executives, are very much aware of the complex issues currently plaguing our economy, and I trust that you, like us, are seeking answers to the problems we face.

As we meet here today, we are once again experiencing both recession and inflation. Growth of real gross national product dropped in the first quarter of this year from a long-term average annual rate of 3-1/2% to a modest 1.1%, and declined by 2.4% in the second quarter. At the same time, inflation has again reached double digit proportions.

Faced with stagflation, we are confronted with a dilemma that could well affect our economic destiny for years to come. We have the choice of going one of two ways. We can ease up on our anti-inflation efforts and attempt to expedite our recovery from the softness we are experiencing by resorting to expansionary monetary and fiscal policies. Or we can deal with the present recession in a manner which will not further fuel the fires of inflation. If we choose the time-worn option of turning on the money spigots to speed our way out of recession, we will increase the prospects of continued accelerating inflation. If we remain steadfast in the belief that inflation is our principal concern, we can work our way out of the current economic slowdown in an orderly fashion while at the same time setting the stage for a gradual reduction of inflation.

This afternoon, I would like to discuss these options.

Let's start by considering which of our two current problems . . . inflation or recession . . . represents the greater threat to our future security. I find myself increasingly disturbed by a pernicious idea floating around these days that inflation is really not so bad . . . that we can somehow accommodate ourselves to it . . . and that a cure for it would be more painful and injurious than the malaise itself. This idea seems to be gaining increasing acceptance to the point where it threatens to provide the rationale for the rejection of policies of fiscal and monetary restraint necessary to come to grips with the problem.

It is important to ask ourselves, "Is inflation in and of itself really such a threat . . is it really so bad?" My answer, in a word, is yes! It is bad for a number of reasons. One is uncertainty caused by inflation which seriously complicates business decisions.

The uncertainty and unpredictability of where prices will be in the future lead to excessive wage and price demands as workers and producers attempt to protect themselves from the erosion of purchasing power. Uncertainty discourages capital investment in plant and equipment, because, in an economy afflicted by varying rates of inflation, an accurate projection of future returns on current investment becomes increasingly difficult.

Uncertainty is but one evil consequence of inflation. Equally costly are the adjustments brought by inflation into the way business is conducted. High interest rates resulting from inflation increase the real cost of idle balances and force businessmen to spend more and more of their resources on money management rather than on the primary functions of production and sales. Sears-Roebuck, in its mail-order selling, in order to keep abreast of inflation-caused cost increases, now publishes four catalogues each year instead of one. Variable rate mortgages and similar financial innovations complicate the conduct of your savings and loan operations.

Still another unfortunate by-product of inflation is increased interference by government in our daily lives. Whether it be wage and price guidelines, interference in international trade, or inflation-induced transfer payments, pressure mounts for more and more government regulation . . . at a time when individuals and businesses alike are already staggering under a burden of often petty and conflicting government rules.

Perhaps the most powerful argument against inflation is that it robs us of the incentive to save, an attribute which has been the cornerstone of our economic order. As more and more Americans invest their savings in tangible assets such as real estate, gold, rare paintings and the like in order to protect themselves from inflation, needed sources of business capital dry up. Without tools and factories, we cannot grow; and without growth, we cannot sustain our standard of living.

All this is not to deny that there is another side to this issue. In recognizing the economic costs brought about by inflation, we cannot ignore the serious hardship imposed on our economy and our people by recessions. In recommending that we focus our immediate attention on inflation, I am not suggesting that we should act in a way that would exacerbate recessionary risks. In acting to combat inflation, we must move with care, because abrupt or excessive actions to cool the overheated economy can indeed lead to recession and serious economic dislocations. It is incumbent upon policymakers in developing monetary policy to keep in mind the importance of acting in a manner designed to minimize the risk of recession. For whenever recession does occur, and increasing numbers of people lose their means of livelihood, political and social pressures inevitably arise for countermeasures which more often than not lead to further inflation and increased risks of recurring recessions.

Yet, the options we have are those which would necessitate a choice between inflation or recession. Inflation can be brought under control without producing recession. It can be done by gradually reducing the growth of the money supply.

As you know, money is the fuel of our economic machine. If it is created too rapidly and available dollars become more plentiful than goods and services produced, prices rise and inflation accelerates. Conversely, if there is too little money to support economic activity, business grinds to a halt and unemployment increases.

There is a direct relationship between the rate at which money grows and the rate of growth of output and prices. Anytime the money supply is increased, economic activity as measured by real GNP is stimulated. This stimulus usually takes effect relatively quickly . . . usually within a few months after the money supply has been increased. Increased money growth has another effect, however. Ultimately, increases in the money supply lead to increased inflation, with the effect on prices usually not being felt until 1-1/2 to 2 years later. Conversely, reductions in the money supply affect the economy in exactly the opposite way. They cause an early temporary reduction in output, followed by a later reduction in prices. The key to an effective monetary policy is to supply enough money to fuel the economic engine in a mixture that is neither too rich nor too lean.

In recent years, in periods of recession or near-recession, such as that which we are presently experiencing, policymakers have tended to expand money supply growth excessively in order to bring about economic recovery. In their zeal to stimulate a quick recovery, they have often paid scant attention to the longer-term inflationary consequences of their actions.

For example, when the economy slowed in 1967, the rate of money growth was boosted drastically from an average 3.8% rate over the previous four years to 5.8%. This caused inflation to jump from 3.4% to nearly 5.5%.

In response to the recession of 1969-70, policymakers permitted money growth to surge to a 7% annual rate, and this, in turn, caused inflation to spurt to an average rate of 7.2%. The 1974 recession, the worst in the post-war period, led to another burst of money creation, this time at a rate in excess of 8%. We are experiencing the effects of that now, with inflation as measured by the GNP price deflator standing at 9.2%. In each of these instances, we excessively expanded the supply of money to lift ourselves out of recession rapidly . . . and each time we paid a fearful price in terms of inflation.

As I have pointed out, the opposite can also cause problems.

Last Fall, for example, the money supply suddenly stopped growing and remained essentially flat for six months. As you will recall, this followed attempts to buttress the dollar in international markets . . . attempts that were quite successful initially. It would have been a worthwhile action, had it not been for the fact that the money supply was contracted too abruptly. M-1 suddenly dropped from 8% to 4%. This kind of sudden reduction in money growth, all else being equal, leads to recession as surely as excessive money growth fuels inflation. What we needed last Fall was a more gradual reduction in money growth. Instead, the rate of money growth was cut in half . . . substantially below what was necessary to sustain output growth. The result is the soft economy we are presently experiencing.

Let's see where we stand at present. There is no question that the economy has slowed down. Real GNP experienced negative growth last quarter and threatens to do so this quarter. In an effort to speed recovery from our current recession, we seem once again to be tolerating excessively fast money growth. Since March of this year, the money supply has shot up alarmingly. In annual terms, it has been rising at a rate of 11%. If we continue to let money grow at an excessive rate in order to pave the way for rapid recovery from the current recession, we will be sowing the seeds of another burst of intolerable inflation two or more years down the road.

Why, we must ask ourselves, do we continue to repeat past mistakes? There is a way to control the growth of the money supply if we would only make use of it. The mechanism is through the open market operations of the Federal Reserve. Let me describe that process.

The Federal Reserve's Open Market Committee, consisting of the seven members of the Federal Reserve Board of Governors and the presidents of the twelve Federal Reserve Banks, meets in Washington ten times a year and sets goals for the growth of the monetary aggregates. Once targets are set, they can be achieved through buying and selling government securities in the open market. When the Fed buys securities, it pays for them by crediting the bank account of the seller, thereby increasing commercial bank reserves. As reserves swell, banks are able to expand their loan volume, and the supply of money increases. When the Fed sells securities, it soaks up bank reserves, loan volume contracts, and the money supply shrinks.

Now, if we are really serious about controlling inflation, all that is necessary is that we establish a gradual and measured rate of growth of money; that we announce our monetary growth goals clearly so that all at home and abroad will understand them; and that we conduct our open market operations in a manner that will achieve those goals. I believe that our policy objective should be to gradually reduce the rate of growth of money from its present long-term annual trend of 7% to a rate that matches the long trend rate of growth of real GNP. This reduction, in order to minimize the prospects of recession, should be accomplished over a period of several years. We should announce that for the next year money will increase at a reduced annual rate, perhaps 6%, which would support economic recovery without creating additional inflationary pressure . . the following year, 5%; the year after that, 4%; and so on until money supply growth approximates the trend growth of output. We must be prepared to adhere to these targets except for adjustments that may be dictated by institutional changes or unforeseen changes in the conduct of monetary transactions, and we must resist the temptation in times of economic slowdown to permit money supply growth to exceed our long-range targets in an effort to achieve quick recovery from recession.

Sounds simple, doesn't it? Unfortunately, although the mechanism exists for controlling the growth of the money supply, there are also contrary pressures that often stand in the way of getting the job done.

First of all, there is a traditional tendency on the part of some monetary policymakers to concentrate on the stabilization of interest rates rather than to seek to control monetary growth. As you know, the Federal Open Market Committee not only sets monetary aggregate targets, but also sets target ranges for short-term interest rates. To more consistently achieve monetary growth targets, it would be necessary to permit short-term interest rates to fluctuate more freely especially in times when monetary aggregate targets and interest rate targets are incompatible. Some policymakers believe freely fluctuating interest rates would be disruptive of financial markets. Quite frankly, I can see no reason why financial markets cannot adjust to free market conditions as readily as the stock market or foreign exchange markets have.

In addition to this resistance to freer fluctuation of interest rates, we can expect pressures for an expansion of the money supply to provide economic stimulus prior to the 1980 elections. After all, office-seekers like to see the economy strong at election time. While I can sympathize with those who might suffer disfavor at the polls if our economy remains soft, I feel more sympathy for the plight of the American people who will be forced to face increased inflation a year or two down the road if we bow to the pressures of the moment and opt for excessive monetary stimulus for purposes of political expediency.

This, then, is the dilemma we face. We cannot have it both ways. Either we resist the temptation to look to monetary policy as a means of seeking early recovery from the current recession . . . and thereby almost certainly assure further inflation in the years ahead, or we exercise monetary restraint in the interest of avoiding future inflation. As I have said, I believe inflation to be the most pressing problem facing our Nation today, and I am confident that most Americans share that belief. We have the machinery for gradually reducing the growth of the money supply in order to wind down inflation. It is a question of whether or not we have the determination to use this machinery effectively.

For nearly twenty years we have tried to stabilize the economy by fine-tuning interest rates. For as long as I can remember, we have tried to work our way out of recessions by increasing the money supply. It is obvious that we have failed on both scores. The inflation we are presently experiencing is a reflection of the failure of past monetary and fiscal policies, and I would hope that we would have learned enough not to repeat our errors.

I am reminded of Robert Frost's poem entitled, "The Road Not Taken."

> "Two roads diverged in a wood, and I .
> I took the one less traveled by,
> And that has made all the difference."

Our Nation has opted to travel the road of expediency, and it has led to a cycle of inflation and recession. I believe the less traveled road . . the path of monetary discipline, careful control of money supply, and a resistance to political expediency in the conduct of monetary policy . . . will better serve us in the long run.