



**ECONOMIC RECOVERY WITHOUT INFLATION**

**Address by  
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I am pleased and honored to have been invited to address this annual meeting of your distinguished State Council on Economic Education. The Minnesota Council enjoys a well-deserved reputation for leadership in the important task of raising the general level of economic literacy in our society. As one who is very much involved in the complicated business of monetary policymaking, I can assure you that, in these times of economic stress, nothing is more important than enhancing public understanding of the factors that affect the course of economic events in our society.

In my tenure as a member of the Federal Reserve's monetary policymaking team, I have repeatedly been struck by a less-than-adequate public comprehension of the economy and what makes it tick. This is regrettable, for in dealing with problems such as inflation, unemployment, recession, and lagging productivity, we simply cannot afford to seek solutions based on anything less than full awareness of the consequences of our policy decisions. We didn't reach the moon by emulating the experiments of the Rover Boys, and we won't resolve the complicated economic problems currently confronting us by resorting to policies and practices that have repeatedly failed us in the past.

As we meet here tonight, our economy appears to be recovering from a recession not unlike others we have experienced in the past. Unemployment is at an unacceptably high level; real output growth has declined well below its post-World War II average; and inflation continues at an intolerably high level.

From the perspective of the economic history of the past three decades, the current situation is not unique. In that time span we have, unfortunately, had no scarcity of either recession or inflation. This is, after all, our sixth recession in the past thirty years; and we have had persistently accelerating inflation for two-thirds of that time. Despite a wide range of well-intentioned efforts by policymakers, we continue to ride a roller coaster of economic gyrations which threatens our economic security and needlessly complicates our ability to make decisions for the future.

As the economy currently moves out of recession, monetary policymakers are once

again faced with the same hard choices that have confronted us in similar phases of past economic cycles. There are those who once more call for strong monetary stimulus to speed up the recovery. They contend that monetary restraint would cause interest rates to rise which, in turn, would choke off recovery. Others advocate a less expansionary course in order to avoid a rekindling of inflation. These are difficult choices which require great care.

Ever since studying history in college, I have been impressed with the lessons the past gives up to those who study it. St. Thomas Aquinas sagely observed, "The art of sailing governs the art of shipbuilding." His counsel to look back from results to the decisions that engender those results, and to adapt fundamental design to reflect actual experience, is especially pertinent for those who are given the responsibility for economic decision-making, where so many shifting, and often contrary, winds buffet us that we often find ourselves preoccupied with the set of our sails and neglect the design of our keel.

With this maxim in mind, I would like to examine the economic events of the past thirty years and the monetary policy responses to them to see what lessons they provide to help us respond to today's challenges. Three fundamental propositions, all concerning the impact of money and monetary policy, provide the framework that underlies my analysis.

The first of these is that persistent inflation . . . the year-after-year rise in the general level of prices . . . is essentially a monetary phenomenon. The core rate of inflation at any particular time is approximately equal to the trend rate of growth in money over some extended time period--typically over the past three to five years. Increases in the trend rate of money growth cause inflation to accelerate; reductions in the trend rate of money growth cause inflation to decline. And, because inflation is the consequence of the long-term trend growth of money, it is relatively impervious to short-term changes in money growth.

The second is that, although short-term changes in money growth above or below trend have little impact on inflation, if such changes are permitted to continue for six months or more, they can have sizeable, albeit temporary, effects on economic activity and output. Major reductions in money growth for six months or more lead to economic slowdowns; major accelerations in money growth provide a temporary stimulus to the economy. In the long run, however, changes in money growth have virtually no lasting effect on output. Lasting growth of output can be achieved only through expanded productivity and growth in factors of production. The only legacy of monetary expansion is inflation.

The third proposition is that changes in the growth of money result primarily from monetary policy actions by the Federal Reserve System. As this Nation's monetary policymaking body, the Federal Reserve can, and does, control the growth of money over all but the shortest periods. Consequently, changes in money growth which temporarily affect real output, and changes in the long-term trend growth of money which, in turn, affect the rate of inflation, are direct consequences of monetary policy actions of the Federal Reserve System.

In the past thirty years, we have seen inflation accelerate sharply and recession recur with alarming regularity. During that time policymakers seemed with disturbing regularity to persist in policy prescriptions that, more often than not, proved to be counterproductive. I have carefully reviewed the events of that period in an effort to determine if the experience of the recent past might not hold the key to sounder action today. Four clear observations emerge from past experience:

1. That whenever the growth rate of money is sharply reduced below its long-term trend for two quarters or more, recession results.
2. That accelerated money growth during a recession will not significantly reduce the duration of the recession.

3. That accelerated growth of money supply during a period of expansion has little effect on the strength or the length of the expansion.
4. That expansion of money growth as a means of hastening recovery inevitably leads to increased inflation.

I base these observations, not on theory, but on the following factual evidence. Each of the six recessions, including the current one, from 1953 to the present, was preceded by a sizeable slowdown in money growth for two quarters or more immediately prior to its inception. For example, money growth in the two quarters preceding the 1960 recession was more than 2% below the trend growth which had prevailed over the previous five years. Similarly, the 1970 recession was preceded by two quarters of significantly reduced money growth approximately 3% below its long-term trend. The same pattern characterized the recessions of 1953, 1957, 1973 and 1980. This evidence clearly supports the conclusion that sharply reduced money growth for two quarters or more contributes substantially to recession.

There is also important evidence that faster money growth during a recession does not significantly reduce the length of the recession. Recessions since 1953 have lasted an average of four quarters, regardless of the rate of money growth during the recessionary period. The shortest, those in 1957-58 and 1960-61, each lasted three quarters. During the 1957-58 period, money grew at an annual rate of approximately 1% below trend. In the 1960-61 recession, on the other hand, money grew somewhat faster than its long-term trend. This difference had no effect whatsoever on the duration of either recession. Similarly, both the 1953-54 and 1969-70 recessions, which lasted four quarters each, were characterized by very different patterns of money growth. In 1953-54, money grew 2% below trend; in 1969-70, money grew at its long-term trend rate. Yet, there was no difference in the length of these recessions. This evidence bears out the fact that, although a sizeable reduction in money growth can precipitate a recession, the duration of the recession depends, in large part, on nonmonetary factors.

A third lesson to be learned from the past is that higher rates of money growth during periods of expansion have virtually no effect on the robustness or length of the recovery. While some would have us believe that monetary stimulus might help to spur greater growth, there is no evidence of any correlation between the rate at which money grows and the strength or length of the expansion phase following a recession. Money growth during the 1975-80 expansion averaged 7% per year, the highest rate of any expansion since 1952. Yet, output grew at only a 4% annual rate . . . the second slowest rate of the five expansion periods. The 1954-57 expansion was one of the longest (it lasted thirteen quarters), in spite of an extremely slow rate of money growth of approximately 2%. I cite these as evidence that we cannot achieve stronger economic growth or economic expansions of longer duration by accelerating money growth during periods of recovery.

Perhaps the most important lesson to be learned from the past is that the accelerated inflation we have experienced over the past twenty years is a direct result of decisions to increase the rate of money growth during all of the recovery periods since 1961. This pattern of accelerated growth of money from one expansion to the next and from one recession to the next was not characteristic of the earlier post-war period. Prior to 1961, the trend rate of money growth, whether viewed from the perspective of trough-to-trough or peak-to-peak periods, generally declined . . . and so did the rate of inflation. For example, using the trough (or bottom of recession) periods for comparison, the trend growth of money fell from 3% in early 1954 to 1.4% by early 1958 and ultimately to 1.2% by the beginning of 1961. The trend growth of money also declined when measured at the peaks of the expansions prior to these three recessions: from 3% in 1953 to 2% in the middle of 1957 to 1% in 1960. Because the trend growth of money declined, the rate of inflation did as well. It fell from 3% per year over the 1954-1957 expansion period to 2% per year during the 1958-1960 expansion.

All of this changed in the 1960s. Since 1961 the trend of money growth has accelerated sharply during both expansion and recession periods, and the rate of inflation has

likewise increased, paralleling the upward movement in money trend. The trend of money growth at the peaks preceding each of the three most recent recessions rose from 5% at the end of 1969 to 6% in late 1973 and 7% in early 1980. The rate of inflation during the expansion phases preceding these peaks rose from 3% in the period 1961-1969 to 5% from late 1970 to late 1973 and 7% for the 1975-1980 expansion. These increases demonstrate just how closely movements in rates of inflation are related to changes in the longer-run trend growth of money.

What does all this tell us about our present situation? It tells us that the sizeable reduction in money growth prior to and during the first two quarters of 1980 was a major factor in the cause and severity of our current recession. Money growth over the second half of 1979 fell 2% below its five-year trend of 7%. Over the first two quarters of 1980, money grew at only a 2% annual rate . . . more than 5% below its trend rate! While higher energy prices contributed to the economic downturn, abrupt and excessive monetary restraint made the recession inevitable.

Secondly, it is clear that, if money growth is held within the Federal Reserve's present target ranges of 4 to 6-1/2% for this year and is reduced gradually starting in 1981, we can look forward to a gradual reduction in the trend growth of money and, consequently, a reduction of the underlying or core rate of inflation. Since the trend growth of money at the beginning of this year was 7%, a gradual reduction is necessary in order to reduce inflation in the years ahead without incurring the adverse output losses associated with drastic reductions. This is what the Federal Reserve's change in policy implementation last October was designed to promote; this is what our publicly announced targets for money growth are intended to achieve.

Finally, our examination of the past reinforces the importance of not overly expanding the growth of the money supply in a mistaken belief that by so doing we can expedite our recovery from the present recession and lengthen the duration of the subsequent expansion. To do so would be a serious mistake which would only assure continued and accelerated inflation.

One would hope that the experience of the past would ensure a more common-sense response to the future. However, we must never forget that monetary restraint has not characterized monetary actions over the past twenty years. Instead, opportunity after opportunity to reduce the rate of inflation by slowing the trend growth in money has been ignored. Reductions in money growth during recessions were inevitably followed by rapid accelerations during the early stages of recoveries. Money was permitted to grow too quickly during all expansion periods since 1961, and this, more than anything else, brought on the inflation we are presently experiencing.

Why was this permitted to occur? I believe that it was the consequence of policymakers' preoccupation with hoped-for, but unattainable, short-term economic benefit at the expense of ultimate inflation.

Today, we once again stand at a crossroads of decision. We are again faced with deciding . . . should we, or should we not, accelerate monetary growth?

In similar situations in the past we usually opted for stimulative monetary policy. Did output growth accelerate as a result? Did recovery occur faster and last longer? The answer is "No." The consequence of past expansionary policies was merely increased inflation which, in turn, contributed substantially to a capricious redistribution of income, a reduced rate of savings, declining investment, and falling productivity.

Let us no longer ignore the lessons of the past and, thereby, sacrifice the potential for long-term economic stability in exchange for short-run advantage. A return to conditions of stable growth is absolutely necessary for our future economic, political, and social well-being. There is no way we can achieve such stability as long as we continue to tolerate accelerating and unpredictable inflation.

Perhaps the time has come when our policymakers should mix a measure of history into their economic prescriptions, for as St. Thomas Aquinas taught us centuries ago, "The time has come to adapt fundamental design to reflect actual experience."