THE KEY TO UNLOCKING THE ECONOMY

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I am pleased to have this opportunity to visit Notre Dame. That the well-known penchant of the Fighting Irish to engage in combat extends beyond the gridiron is demonstrated by your courage, in these times of economic anguish, to invite an advocate of monetary restraint to address you. I must observe that you are not alone in your courage. It's equally dangerous for an official of the Federal Reserve to appear in public these days in the face of widespread public perception that it is Federal Reserve policies that are responsible for so many of the problems . . . both financial and real . . . that currently plague this Nation.

This object that I am holding in my hand is a key. It is one of thousands of similar keys that have been delivered in recent weeks to Federal Reserve officials throughout the nation. These keys come from representatives of the home building and automobile industries who are calling upon the Fed to "unlock the economy." Apparently these well-intentioned individuals think that all that is needed to restore prosperity to their businesses is to turn a key and all will be well.

Now, the only means available to the Fed to "unlock the economy" is its ability to control the rate at which money is injected into the economy. I assume that those who have been distributing the keys believe that monetary policy has been too restrictive and that the slow growth of the money supply has been responsible for the rise of interest rates and the present plight of interest-sensitive segments of the economy.

Although the thought of Federal Reserve officials buried up to their ash trays in keys may be momentarily amusing, both the intent behind the key campaign and the consequences that would arise should the Federal Reserve respond to it by accelerating money growth are extremely serious. This evening I would like to tell you why I believe that

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current criticisms of monetary policy are ill-directed, and thereby hopefully to convince you that accelerating monetary growth to comply with the demands to "unlock the economy" would be ill-advised and of little avail in bringing relief to the auto and housing industries or, for that matter, to any other parts of the economy.

First of all, consider the reasoning behind the sending of the keys. It is based on a belief that slower money growth drives interest rates up and faster money growth pushes interest rates down. That belief is simply invalid; those who persist in believing it ignore the vast amount of empirical evidence that directly refutes the notion that slow money growth brings about high interest rates.

You don't have to be an econometrician to know that exactly the opposite is true . . . faster money growth brings higher interest rates. Look at interest rates in various countries around the world. Which countries have lower rates -- those with faster money growth or those with slower money growth? From 1977 through 1980, for example, the annual rates of money growth in Switzerland, the U.S. and Italy were 4.7 percent, 7.4 percent, and 22.5 percent, respectively. During that period interest rates were lowest in Switzerland, the money growth underachiever, and highest in Italy, the money growth overachiever.

To cite yet another example, from 1954 to 1966 money growth averaged about 2.5 percent per year in the U.S. and interest rates averaged about 3.5 percent. Since 1966, annual money growth increased to about 6.5 percent and interest rates have risen to an average of 7.5 percent. The increase in the average growth rate of money since 1966 is directly reflected in higher interest rates.

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I doubt that many of you would find this longer-run association between money growth and interest rates surprising. What might be surprising, however, is the fact that, even in the shortest of time periods, there is a positive relationship between money growth and interest rates. Each week, on Friday afternoon, the Federal Reserve announces the money stock numbers for the week ending about nine days earlier. For reasons that are as yet unfathomable, at least to most academicians and monetary policymakers, financial market participants eagerly await these weekly money numbers. Although it is not clear exactly why the weekly results should affect interest rates, it is interesting to note that announcements that the money stock has increased during the previous week tend to raise interest rates and announcements of decreases in money tend to lower them. Once again, this observed pattern directly refutes the notion that faster money growth somehow depresses interest rates, for even on a weekly basis, we find that faster money growth produces higher interest rates.

There are three basic propositions that help to explain the true relationships between money growth, inflation and the behavior of financial markets. They are:

1) That, holding other things constant, an acceleration in money growth will, with some time lag, result in greater inflation.

2) That financial market participants are no different from other people in having a keen interest in preserving and, hopefully, augmenting their wealth. Therefore, the rate of expected inflation at any time will influence the supply and demand for credit and, accordingly, will affect

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interest rates in a predictable way: higher expected future inflation rates will drive up interest rates, lower expected inflation will bring rates down.

3) That financial markets are relatively efficient. Financial market participants, in influencing interest rates, are unlikely to overlook the implications of increased money growth for increased future inflation.

Based on historical experience, there is little question of the validity of these propositions. Taken together, they add up to the inescapable conclusion that increasing the rate of money growth will tend to raise interest rates. And this is what many critics of current Federal Reserve policies seem to totally ignore!

In my opinion it would be a tragic mistake for the Fed to respond to current criticism by accelerating money growth, even temporarily. Let's take a look at what happened in the past when the Fed caved in to public pressure and resorted to monetary expansion to stimulate a weak economy. Consider 1969 when, after almost a decade of accelerated money growth, inflation, and rising interest rates, the Federal Reserve sharply reduced the rate of money growth for several quarters. Interest rates began to decline as the rate of inflation was expected to slow. However, pressures soon developed for the Fed to alleviate low output growth by once again accelerating money creation. The Fed obliged, and although partially obscured by the 1971-73 price controls, higher inflation resulted. Similarly in 1974 and 1975, the Federal Reserve again slowed money growth temporarily; but, once again, in response to pressures from the public, money growth was sharply increased. And again, higher inflation and higher interest rates

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followed. This repeated inability to sustain reduced monetary growth in the face of public pressure had a cumulative effect of causing the long-term trend rate of growth in money to rise from 1.5 percent in 1960 to approximately 7.5 percent now, and directly produced the inflation we are presently experiencing.

Given this pattern of past performance, it is not surprising that interest rates have remained high despite the recent slowing of monetary expansion. Money growth has remained relatively slow for only about seven months. While I am convinced that this time the Federal Reserve is determined to hold firm in its policy of monetary restraint despite increasing public pressure to back off, it is no wonder that market participants, after the experience of the past 20 years, are skeptical of what the future holds. They recall how often in the past attempts by the Fed to tighten money growth long enough to reduce inflation were abandoned and how they were almost always followed by extended periods of accelerated money growth, rising inflation, and higher interest rates. In order to disabuse skeptics of their doubts and to demonstrate in a convincing manner that past mistakes will not be repeated, it is more important than ever that the Federal Reserve resist current exhortations to "unlock the economy" by expansionary monetary measures. To do otherwise would merely confirm, once again, the inflationary expectations that still persist.

Consider, if you will, what would happen if the Federal Reserve did accelerate money growth? What "benefits" could the advocates of "unlocking the economy" expect to achieve as a result? We know, from past experience, that sizable short-run increases in money growth do generate faster real economic growth. We also know, however, that this

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impact is extremely short-lived, lasting no more than a few quarters before it dissipates. At best, faster money growth might provide some temporary stimulus that might cover-up, but certainly would not cure, the fundamental problems affecting the economy.

But consider the cost of such short-term relief! Any abrupt monetary policy shift toward expansion would actually intensify rather than relieve our real economic problems. Inevitably, erratic stop-go monetary gyrations lead to higher and more erratic inflation, higher and more variable interest rates. This in turn contributes to declines in savings, reduced investment, and slow economic growth -- precisely what the apostles of "quick-fix" measures hope to avoid. There is no way that faster money growth at this time would resolve our present economic woes; it would only worsen our problems.

But what about the plight of the auto industry and the housing industry? There is no doubt that these sectors have been victimized by high interest rates, as have many financial institutions and virtually anyone who has purchased long-term bonds in the past few years. Faster money growth, despite allegations to the contrary, would not help them, nor would erratic policy that would produce widely varying growth in money from quarter to quarter and year to year. In fact, these industries are suffering now because of precisely such policy reversals in the past.

So what can be done to bring relief to interest-sensitive industries such as autos and housing? How long must they be made to endure their present problems?

I'm willing to stick my neck out and say that the process leading toward recovery is already underway. Even though unemployment

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has risen to 8 percent and may continue to stay at these unacceptable levels for awhile longer, I believe that adjustment forces are in motion that will produce more traditional relative prices and more robust economic activity. Interest rates have dropped substantially: The commercial paper rate has declined from 18 percent in May to 14 percent; Treasury bill rates have decreased from close to 17 percent in May to 12.5 percent. The federal funds rate has slipped from 20 percent to 15 percent. And while these interest rates still seem to be high by traditional standards, given the current and expected rates of inflation, they are not so much out of line. I say this for the following reason. Assuming that inflation as measured by the GNP deflator is expected to be 8 percent in 1981, and that 3.5 percent of any interest rate represents taxes on interest income, lenders currently need to receive an 11.5 percent return merely to break even. If to this is added 2 to 3 percent real interest, we end up with what might be considered a "normal" nominal interest rate of 13 to 14 percent. This is where short term rates currently are. It also demonstrates that further reductions in the rate of inflation could be expected to bring lower interest rates.

The significant reductions in interest rates that have already occurred are essentially in the short end of the spectrum. Rates for longer term instruments are declining much more slowly. Mortgage rates are still stubbornly hanging in the 17-18 percent range and corporate AAA bonds are lodged in the 15-16 percent area. This, at least to me, implies that while the markets expect inflation to come down in the short run, there is still a significant degree of uncertainty as to what will happen in the long run. The market still believes that a monetary explosion could occur which would lead to further inflation. Ironically,

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those who advocate monetary expansion to bring down interest rates are actually fueling the fears of further inflation and causing the very interest rates that they would like to come down, to remain persistently high.

This is why we are at such a critical phase in monetary policy and why the Federal Reserve must resist expanding the money supply as a means of "unlocking the economy." Unleashing the growth of money would not unlock the economy. It would only lock in higher rates of inflation, increase financial market unstability, and generate greater economic problems for this nation. The only way to bring interest rates down and keep them down is to adopt, advertise, and adhere to a policy of gradually <u>reducing</u> the growth rate in money. This is the only key that will unlock the economy.

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