



1982: A CRITICAL YEAR

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It's good to be back at Rotary, and I appreciate the opportunity to share with you some impressions of the current state of the economy.

I last addressed this organization a little more than two years ago at a time when inflation was at double-digit rates and rising, and when the Federal Reserve had just announced a significant change in its manner of conducting monetary policy. The change was designed to place greater emphasis on controlling the growth of the money supply as a means of bringing about a reduction in inflation. In that speech I described the relationship between the rate at which spendable money is permitted to grow and the rate of inflation, and I advocated a gradual reduction in monetary growth as the best means of bringing about a reduction of inflation.

The events of the past two years, I believe, have vindicated that position. Money growth as measured by M-1 (i.e., currency and checkable deposits) has declined from an excessive annual rate of 7.5 percent in 1979 to 5.1 percent in 1981, and the Federal Reserve target for this year is approximately 4 percent. As a consequence of the declining money growth in the past two years, inflation, as measured either by the GNP deflator or by the consumer price index, has dropped dramatically. The GNP deflator came down from 9.3 percent in the first quarter of 1980 to 8.4 percent by the end of last year; the annual growth rate of the Consumer Price Index has plummeted from 18 percent in January, 1980 to 5.2 percent last December.

Under normal circumstances this improvement in inflation should have resulted in a rapid and continuing drop in interest rates and

should have set the stage for a long overdue resurgence of capital investment by business as well as a rebound in economic activity. For several reasons this has not occurred.

One problem has been the erratic manner in which the decline in money growth occurred. Instead of a gradual decline which would have minimized turmoil in the real economy, the pattern of monetary growth has been quite volatile. M-1 grew at a 7 percent rate in the first quarter of 1980, declined at a 3 percent rate in the second quarter of 1980, grew at a rate of 10 percent through the first quarter of 1981, and declined to 5 percent during the remainder of that year.

These erratic gyrations in money growth did not inspire confidence in financial markets. While Federal Reserve targets have been clearly anti-inflationary, the actual pattern of money growth signaled alternatively faster and slower increases in the rate of inflation. With inflationary expectations changing so rapidly, the long-run outlook for monetary growth and inflation intensified the risk factor and contributed to unusually high and unpredictable interest rates.

At the same time, uncertainty about the national administration's fiscal policies began to mount. Late in 1980, it was announced that government spending would be reined in and that, despite large tax reductions, deficits would decline. However, as the economy slowed in the second half of 1981 and government revenues began to decline, deficits began to rise and rumors of unexpectedly large future deficits spread alarm throughout the financial markets. These fiscal problems also have contributed to the disappointing interest rate behavior in 1981.

So much for the past. What does the future hold? I believe that the year 1982 will go down as one of the most crucial decision points in American economic history. The decisions we make this year will determine whether the economy will return to conditions of noninflationary stability so necessary for the rejuvenation of our economic machinery, or whether we will face continuing high inflation, even higher interest rates than we are now experiencing, and the prospect of endless stagflation.

Involved in this drama are the Federal Reserve, which has responsibility for conducting monetary policy, the federal government which must make the fiscal decisions that will determine the extent of future budget deficits, our elected officials who must decide whether or not to place the national interest ahead of their personal political ambitions in November and the general public who must resolve to endure the temporary discomfort necessary to achieve a permanent cure for our current economic malaise. Each of these has an important role to play.

The Federal Reserve has the responsibility for regulating the rate at which money grows. By constraining the growth of money to the growth of available goods and services, the Fed can reduce inflation. If we are to achieve a lasting reduction in inflation, we must continue to control the growth of M-1. If the Federal Reserve succeeds in achieving its growth targets for M-1 as recently announced by Chairman Volcker, we can be confident that inflation will continue to decline.

It is important that the reduction of money supply growth be accomplished in a stable and gradual manner. For we know that erratic

short-term fluctuations in money growth impose heavy costs on the economy in terms of unemployment, increased risks, gyrating interest rates and difficulties in adjustments to changing price levels. To avoid these problems, the Federal Reserve must continue to assess the feasibility of improving its operating procedures in order to achieve its targets in the most orderly manner possible.

But the Fed cannot do the job alone. Monetary restraint must be accompanied by fiscal restraint. The federal government must continue to seek ways to constrain budget deficits. This is important because large deficits have usually resulted in excessive money growth as the Fed monetized larger and larger portions of the debt through increased purchases of securities in the open market. This, in the past, has led to increased inflation and higher interest rates.

Furthermore, large deficits add to aggregate credit demands as government borrowing competes with borrowing needs of the private sector. In the past, this has had a "crowding out" effect on private investment and has increased the level and volatility of interest rates. There is no question in my mind that recent announcements of higher anticipated budget deficits have had a destabilizing effect on financial markets and caused interest rates to rise.

Now neither the Federal Reserve nor the federal government operates in a vacuum. Each is subject to pressures from elected officials and the public at large.

Political influences on monetary and fiscal policymaking can be expected to be particularly pronounced this year as we approach the November elections. It is perfectly understandable that congressmen, facing reelection, would prefer to campaign in an atmosphere of

economic prosperity. We know that monetary and fiscal expansionism can have a short-term stimulative effect on the economy, and we know that the inflationary consequences of such expansionism is only felt after a lag of a year or more. Even the most responsible official when seeking reelection is bound to be tempted to support stimulative policies in an election year, notwithstanding the certainty of higher inflation later.

And here is where the public at large has an essential role to play. It cannot be denied that the anti-inflationary measures of the past two years have brought serious discomfort to certain segments of the economy. Unemployment is intolerably high. Interest-sensitive industries such as the home-building and thrift industries are suffering serious distress. It is not surprising that many businessmen are looking for ways by which to "unlock the economy" in order to bring interest rates down.

In earlier times when inflation and inflationary expectations were not the factor they are today, the Federal Reserve could, by increasing the money supply, exert some temporary downward influence on interest rates. Unfortunately this is no longer the case. Today, in this inflationary economy, interest rates respond positively to inflationary expectations. If lenders expect higher inflation, they will price their loans accordingly. Financial markets respond similarly. We have surveyed market responses to changes in money growth, and we know that increases in money growth are almost instantaneously followed by increases in interest rates.

Thus, anyone who believes that monetary expansion in the face of massive budget deficits would bring downward pressure on interest

rates is engaging in self-delusion. Interest rates will decline and stay down only when participants in financial markets become convinced that anti-inflationary monetary and fiscal policies are "for real" and that such policies will persist until inflation is eliminated.

This is why I believe 1982 to be such a critical year. We are at a crossroads. Our choices are quite obvious. We can opt for what might seem the easy way out of our present predicament by expanding money growth and encouraging more spending by the federal government. To those who are grasping for a "quick fix" to our current economic problems or to candidates for public office who fear the consequences of a soft economy at election time, these options have some appeal.

But think of the costs involved! Excessive monetary expansion and irresponsible deficit spending will accomplish only one result . . . a return to double digit inflation and even higher interest rates for years to come.

An alternative option is to stick with the policies that have already brought about a decline in inflation, and to endure whatever pain is necessary to permanently eliminate inflation. Although such remedial medicine is a bitter prospect for some, to change course now at a time when recovery is in sight would be the height of folly.

We have a clear choice. We can either tolerate inflation and witness the decline of America as a great economic power . . . or we can eliminate inflation and restore the foundation of stability and growth so necessary for our national survival. This is the choice for 1982.