

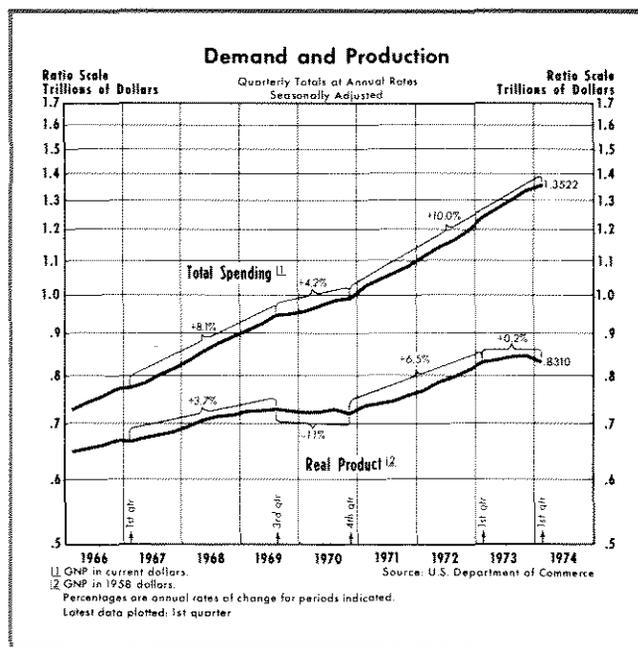
A Monetary Prescription for an Ailing Economy

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Bank of St. Louis To Steel Plate Fabricators Association
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IT IS good to have this opportunity to present my views regarding inflation and the economic outlook. I find it rather sobering to reflect that our country, as well as most other major industrial countries, has experienced almost a decade of rising inflation. In reviewing economic history, I find that we are at a point similar to 1939 in that then too our country, along with the rest of the world, was ending a decade of economic difficulty — a recession. The disquieting similarity is that in both instances some prominent individuals could see no end to the situation in sight and counseled us to learn to live with it.

I rejected the idea then and I reject it now. I continue to believe that we have the knowledge to bring this devastating inflation under control. Economic stabilization actions formulated and acted upon now will be the most important influence on our economy, not only during late 1974, but over the balance of the 1970s. Our present concern is for simultaneously reducing inflation and permitting growth of output to return to a rate consistent with optimal utilization of our nation's productive potential.

Recently, two sharply divergent views have been advanced regarding the proper course of economic stabilization policy at this time. One view is that expansionary actions must be taken immediately to guide the economy to so-called "full employment". The other view is that restrictive actions must be taken to reduce the rate of inflation.



The recognized importance of stabilization actions for the future, and the conflicting recommendations surfacing around us, dictate that we examine the experience of stabilization actions over the last decade to seek out some lessons which can be helpful in selecting an appropriate course of action now and for the future. The last decade was one of accelerating inflation and, at times, deviations of output growth from our nation's productive potential.

In developing some of the lessons from past stabilization efforts, it is helpful to make a brief survey of the premises which had a dominant influence on policy actions taken over much of the past decade. Once these have been outlined, the experience of the past decade will be reviewed to evaluate the usefulness of these premises as a basis for undertaking future stabilization actions. Finally, against the background of these lessons, the implications for inflation and the economic outlook of the two policy alternatives will be discussed.

PREMISES OF STABILIZATION POLICY OVER THE PAST DECADE

Let us now review the premises which guided stabilization efforts during the past decade. A foremost premise was that positive government actions were required to produce proper growth of output of goods and services so as to assure "full employment" of our labor and industrial resources. In other words, many observers contended that without active government guidance our economy would tend to produce an unacceptable level of employment and growth of output.

There were two premises regarding the causes of inflation. One premise was that inflation, for the most part, did not normally occur unless aggregate demand for goods and services was "pushed" to a level close to or greater than our economy's ability to produce. But this need not happen, it was argued, because government actions could be used to assure that the level of aggregate demand would never be in excess of capacity output.

The other premise was that special factors could, at times, cause inflation. Some important factors cited were the use of industrial monopoly power, the exercise of labor market power by strong unions, special conditions in major domestic markets, and rising prices of internationally traded commodities.

In summary, it was believed that so-called "full employment" of our resources would not naturally occur; therefore, government should take actions for promoting growth of aggregate demand so that output would be at our economy's productive potential. Given skillful application of aggregate demand management, inflation need not occur, except for that attributed to special factors which were believed to be beyond the control of traditional stabilization tools.

Four major propositions guided the implementation of economic stabilization policy over most of the last decade. First, the dominant view was that fiscal actions, that is, changes in government spending and

taxing programs, were the most effective means for guiding the course of output along a non-inflationary, "full employment" path. Second, monetary actions were viewed as being of minor importance. Federal Reserve actions were assigned an accommodative role in the sense that they should be directed toward promoting a level of market interest rates consistent with the over-all intent of stabilization policy. A third proposition was that management of aggregate demand should be conducted on a short-run basis of a few quarters. The fourth proposition was that selective incomes and price policies were necessary to control inflation arising in monopoly industries and in industries dominated by powerful labor unions.

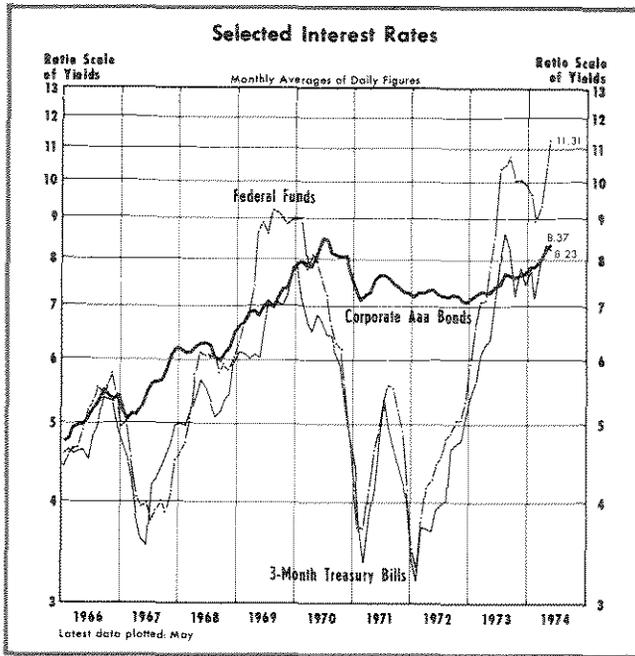
STABILIZATION ACTIONS TAKEN

An examination of the record indicates that stabilization authorities were very busy over the past decade. The policy tool that received the most attention during that time was fiscal actions. I will cite just a few examples of its use. There was the Revenue Act of 1964 which included across-the-board rate reductions in personal and corporate income taxes; the Revenue and Expenditure Control Act of 1968 which imposed a temporary ten percent surcharge on personal and corporate income taxes; and the on-again, off-again, investment tax credit. At times, such as in 1969, 1971, and 1973, attempts were made to hold down increases in government spending.

The Federal Reserve was also very active in economic stabilization during the past ten years. For example, from 1964 to 1973, the Federal Open Market Committee, commonly referred to as the FOMC, met 141 times, and at seventy percent of these meetings a policy of restraint was adopted. Only in 1967 and 1970 did the FOMC adopt a policy of ease at virtually every meeting.

Throughout most of the past decade FOMC actions were directed mainly toward promoting an appropriate level of market interest rates. For the most part, these actions can be said to have been accommodative, in the sense that although interest rates were permitted to rise, the FOMC attempted to restrict interest rates to levels believed to be not so high as to interfere with the achievement of full employment. Even though more emphasis was given to movements in monetary aggregates late in the decade, open market transactions continued to be subject to an interest rate constraint.

Finally, when inflation threatened to reaccelerate in 1971, a time of excess capacity, it was believed by



many that the inflationary situation was due to special factors; as a result, price and wage controls were adopted. Since then, these controls have gone through two complete cycles—from freeze to guidelines to thaw, then back to freeze, guidelines, and phase-out. For the most part, these controls were administered on a selective basis.

UNDESIRE RESULTS CAN SERVE AS LEARNING EXPERIENCE

What have been the end results of these activist economic stabilization actions taken over the past decade? Our economy has experienced a high, and accelerating rate of inflation, which still persists. There was a shallow recession in 1970, followed by a period of slow recovery. Market interest rates rose to their highest levels in fifty years. At times severe dislocations occurred in commodity, labor, and financial markets. At the present time our economy is undergoing what some have labeled "stagflation".

From these events it is quite apparent that, in spite of good intentions and much effort, economic stabilization actions have not produced desired results. So let us now examine this experience for some lessons which may be helpful in planning future stabilization efforts.

Accelerating inflation started when our economy began to operate at capacity levels in the mid-1960s, tending to confirm the view that mismanagement of aggregate demand could cause inflation. But then in 1970 and 1971, when output fell and continued to re-

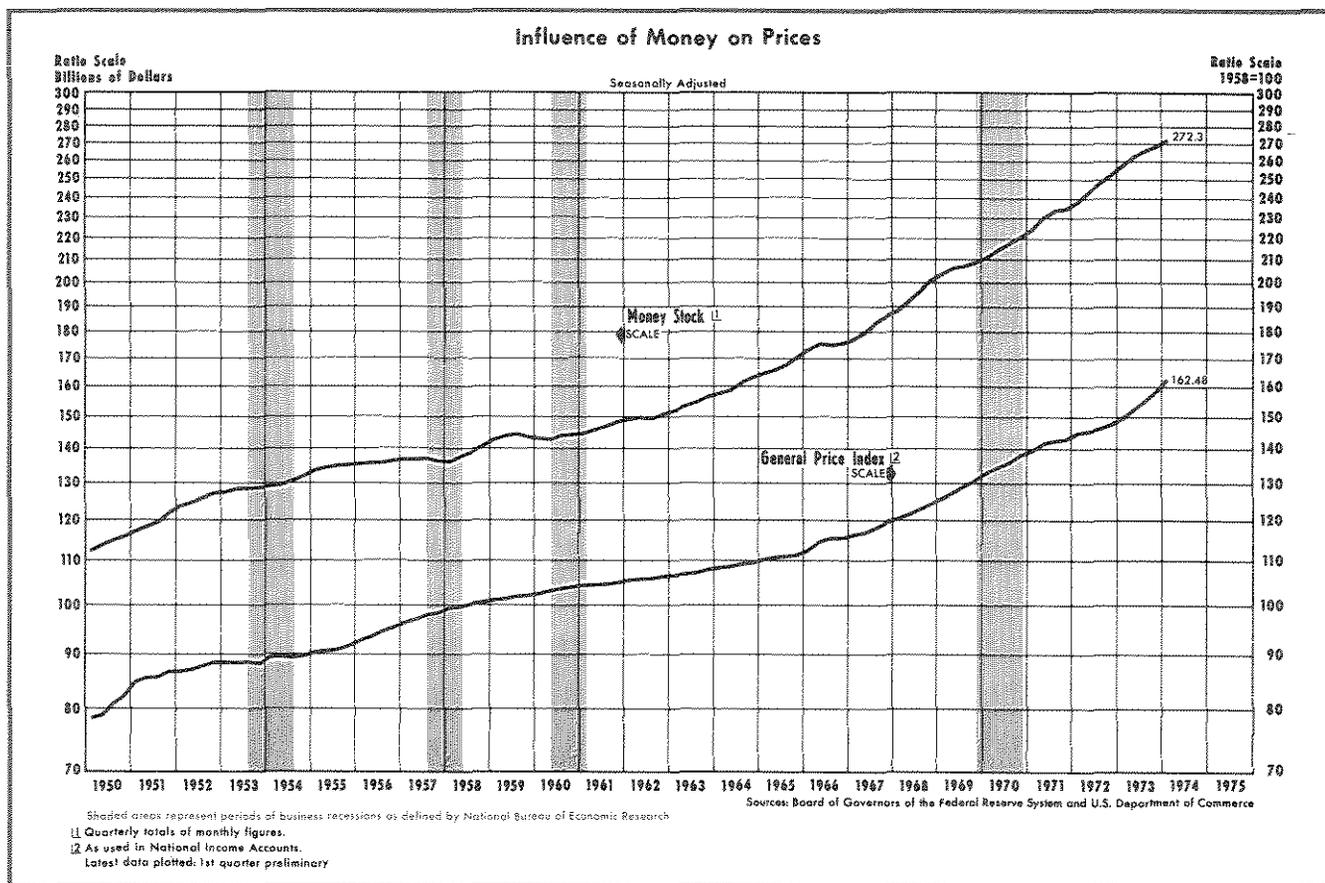
main considerably below capacity, inflation remained high, contrary to the view that inflation would quickly subside when aggregate demand was less than capacity output. So, the cause of inflation was *then* attributed to monopoly and labor union power. But the record of the decade indicates that there was little, if any, increase in industrial concentration and that membership in labor unions as a percent of the labor force actually declined.

Thus, it appears that it was a fallacy to base monetary and fiscal actions on the proposition that they need to be concerned about inflation only when aggregate demand is pushed in the neighborhood of our economy's productive potential. A second fallacy, suggested by this experience, was that the rate of inflation would quickly subside if aggregate demand is held below productive potential for only a few quarters. A third fallacy was that industrial monopolies and labor unions are an important cause of inflation.

Another lesson from the past decade's experience is that an activist policy cannot easily guide aggregate demand in such a manner as to promote a relatively low unemployment rate with little inflation. Since 1961, the beginning of activism in economic stabilization, the unemployment rate has averaged 4.9 percent. This is the same as in the Eisenhower years, a period which most activists would contend was not particularly noted for efforts to promote a substantially lower unemployment rate. The major difference between these two episodes is the rate of inflation. The overall price index rose at a 2 percent average annual rate from 1952 to 1960, and continued to rise slowly until the mid-1960s. But then the rate of price increase accelerated, and has been at about a 5 percent rate since 1968.

Another lesson is that price and wage controls are not an effective method of curbing inflation when aggregate demand is near capacity output, contrary to the dominant view of the past decade. The implementation of such controls in 1971 quickly led to many disruptions in the functioning of markets and reported inflation remained high, except in the freeze periods. After almost three years they have been abandoned.

Experience over the past ten years casts strong doubts regarding the effectiveness of fiscal actions in guiding the economy along a desired path. Adoption of the income surtax of 1968, and the imposition of curbs on government spending since 1968, were taken for the purpose of slowing growth of aggregate demand. With the exception of 1970, a recession year,



growth of aggregate demand accelerated each year. For the period 1968 to 1973, current dollar GNP rose at an average 8 percent annual rate, compared with a 7 percent rate from 1960 to 1968, and a 5 percent rate from 1952 to 1960.

A final set of lessons, and I believe the most important ones, are in regard to prevailing views of monetary actions. One view was that monetary actions were important in only an accommodative sense of keeping interest rates from rising too high or too rapidly. Another view was that the influence of monetary actions was best measured by movements in market interest rates, not by changes in growth of the money stock.

The validity of these propositions has been questioned as a result of the experience of the past decade. An extensive body of research has emerged regarding the influence of monetary actions, measured by changes in the money stock, on economic activity. Rather than cite specific research studies, I will summarize some conclusions of these studies.

First, there is considerable evidence consistent with the proposition that inflation is primarily a monetary

phenomenon. This proposition holds that an increase in the trend growth of money is followed by an increase in the rate of inflation. This proposition thus attributes the basic cause of our present inflation to the accelerating trend growth of money since the early 1960s. The money stock rose at about a 2 percent average annual rate from 1952 to 1962, accelerated to a 4 percent rate in the period ending 1966, accelerated further to a 6 percent rate in the period ending 1971, and has been at about a 7 percent rate since then. Accelerations in the rate of inflation have followed accelerations in the trend growth of money.

Second, these studies present evidence consistent with the proposition that short-run accelerations and decelerations in the rate of money growth are followed, with a short lag, by similar movements in growth of real output. It is thus concluded that monetary actions, measured by changes in the money stock, are an important cause of economic fluctuations.

A third lesson is that market interest rates are a poor indicator of the tightness or ease of monetary actions, and that the use of market interest rates in conducting monetary policy can ultimately lead to accelerating inflation. Most economists now accept the proposition,

which was rediscovered in the past decade, that market interest rates embody an inflation premium. According to this proposition, accelerating inflation is accompanied by rising market interest rates. To the extent that an accelerating trend growth of money results in accelerating inflation, the high interest rates of the past decade do not indicate monetary restraint. Instead, they indicate previous excessive monetary ease. Moreover, attempts by monetary authorities to resist rising market interest rates, following their recommended accommodative role, required larger purchases of government securities in the open market which ultimately resulted in faster money growth, greater inflation, and still higher interest rates.

Another lesson is that government deficits are an important cause of accelerating money growth. Large deficits, other factors held constant, tend to increase market interest rates, which in turn have been resisted by monetary authorities. Such resistance was consistent with the accommodative role assigned to monetary actions. These rapidly growing purchases of government securities provided much of the basis for the accelerating growth of money.

A final lesson regarding monetary actions is that if inflation is to be avoided, these actions should be directly concerned with inflation and carried out on a long-run basis. This is contrary to the prevailing view that monetary actions should be primarily concerned with output and employment and should be conducted on a short-run basis. Monetary actions during the last ten years have been directed, at various times, toward achieving such short-run objectives as lower market interest rates, protection of thrift institutions and the housing industry, or a reduction of the unemployment rate. In attempting to achieve these objectives, the trend rate of money growth has been ratcheted upward. The end result has been the present high trend rate of monetary expansion and high inflation.

CURRENT ASSESSMENTS AND POLICY PROPOSALS DIVERGE

It is my opinion that the economic outlook depends critically on how stabilization actions are altered in view of the aforementioned lessons. With these lessons in the background, let us now examine some of the implications for inflation and the economic outlook.

Over the past four or five months a wide divergence has developed in economists' evaluations of the underlying strength of the economy. There are those who have viewed the economy as being weak and getting weaker. Considerable concern has been raised

about the prospects for rising unemployment and falling real output. Other economists believe the economy is basically strong, and they are greatly concerned about inflation.

Now that the latest report on the national income accounts indicates, as was widely expected, that output of goods and services fell sharply in the first quarter, some politicians from both major political parties and many well-known economists have called for stimulative government action. They do so in spite of an acceleration of inflation to about an 11 percent annual rate in the first quarter.

They argue that the purchasing power of households is being so eroded by inflation that there is insufficient aggregate demand relative to our country's productive potential. According to that view, a tax cut is needed immediately to increase household purchasing power in order to boost aggregate demand and to prevent further deterioration of output and employment. Some who hold this view have also urged that the Federal Reserve actively seek lower market interest rates in order to achieve what they would consider to be an easier monetary policy designed to stimulate housing and capital investment. The analysis underlying this recommendation is based on the same approach that dominated thinking about stabilization policy over the past two decades.

In contrast to that position is the one I share with the other group of economic analysts. That is, the economy is fundamentally very strong and there is more than adequate aggregate demand to promote real expansion. I view the slower growth in real output after the first quarter of 1973 as being attributable to the economy operating "flat-out" at full capacity in an environment where price and wage controls severely reduced the efficiency of the market system in allocating resources in the production process.

I do not see how the existence of wide-spread shortages of commodities and sharply rising prices can be viewed as characteristics of weak aggregate demand. The sharp drop in real output in the first quarter of this year was clearly the result of the oil boycott and related developments such as the truckers' strike, the allocation program, and the presence of controls on both prices and resource movements. Only a few industries were affected and all of them were energy related. Furthermore, unemployment in the first few months of this year was much smaller than one would have expected if the sharp drop in real output had been widespread and had resulted from fundamental weakness in the economy.

One important aspect which has been overlooked in most analyses of the current economy is that all previous economic recessions have been preceded by a period of sharply reduced growth in the nation's money stock. In my view the growth of money is a reliable indicator of the tightness or ease of stabilization policies. Since the growth of money last year was not much slower, on balance, than in 1972, and the 7 percent average rate of growth in money over the past three and one-half years is the fastest for any such period since World War II, I don't think we have had such restrictive actions as would cause a recession. In fact, the approach I would take suggests that so far the steps necessary to bring an eventual end to the inflation have not been taken.

SELECTING AN APPROPRIATE COURSE OF ACTION

Now, given that there are two opposing assessments of the economic situation and, therefore, opposing prescriptions, one is faced with a choice. Suppose we were to adopt the policies of those who think the economy is weak and take actions to push interest rates down, accelerate money growth, and possibly cut taxes. Based on the lessons of the past, I believe that later this year we would find aggregate demand remaining excessive. In such circumstances, inflation would not subside significantly, and further upward adjustment in the premium on interest rates attribut-

able to expectations about inflation would give us still higher market interest rates. Consequently, the task of cooling the economy would be even more difficult than it is currently.

Given that situation, it would be necessary to shift to decisively anti-inflationary policies. To do so would mean going into 1975 with an even higher structure of interest rates, a more rapid rate of inflation, and, because of the newly adopted restrictive policies, declining growth in output and rising unemployment. If my assessment of the economic situation is correct and we follow policies of those who want to fight a recession now, then the probability of both a recession and a faster rate of inflation in 1975 is greatly increased.

Let's consider the opposing approach. Those of us who see aggregate demand as being very strong and inflation as the most serious problem would argue that the trend rate of money growth should be reduced immediately to about a 5 percent rate for the balance of this year. The actions necessary to achieve this might involve even higher short-term market interest rates for a few months, but then late in the year or early next year we would be making tangible progress toward both less inflation and lower interest rates. Past experience suggests that following this course would minimize the risk of further acceleration in the rate of inflation while also setting the stage for further real output growth next year.

