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Statement by

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before the

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I am pleased to appear before this Committee today to discuss the six questions posed by Chairman Patman's letter of June 19, 1974. The several areas addressed by these questions are of great interest, particularly to professional economists. My comments on them convey the basic thinking of the Board of Governors, and will -- I believe -- be responsive to the Committee's needs.

I must, however, go beyond a narrow or technical interpretation of these questions. Rapidly rising prices, rapidly rising wages, rapidly rising interest rates -- these are the burning economic issues of our time. My testimony today will seek to identify the sources of this menacing inflationary problem and to outline the course that public policy must take to restore price stability.

The first question raised by Chairman Patman concerns the reliability of the trade-off between inflation and unemployment -- the so-called Phillips curve -- as a guide for monetary policy. The discovery some years ago of a statistical correlation between the rate of inflation and the rate of unemployment seemed to offer a straightforward choice to policy makers. These early studies --

using data first for the British economy, later for the United States and other economies -- suggested that unemployment could be reduced if a nation were willing to put up with more inflation, and that advances in the general price level could be slowed down if a higher rate of unemployment were tolerated.

Further research and subsequent developments have indicated, however, that simple statistical correlations of this kind are misleading. The forces affecting economic activity and prices in a modern economy are far too complex to be described by a simple mathematical equation.

We found in 1970 and early 1971, for example, that increases in wage rates and prices may continue -- and even accelerate -- in the face of rising unemployment and declining real output. The experience of the United States in this regard was not unique; similar developments occurred at about the same time in Canada and the United Kingdom.

We have also come to recognize that public policies that create excess aggregate demand, and thereby drive up wage rates and prices, will not result in any lasting reduction in unemployment. On the contrary, such policies -- if long continued -- lead ultimately to galloping inflation, to loss of confidence in the future, and to economic stagnation.

The central objective of monetary and fiscal policies should be to foster lasting prosperity -- a prosperity in which men and women looking for work are able to find work; a prosperity in which incomes and savings are protected against inflation; a prosperity that can be enjoyed by all. Of late, such a prosperity has eluded us, because we have not yet found a way to bring an end to inflation.

Let me turn to your second question, concerning the benefits and risks involved in the Federal Reserve accommodating increases of the general price level that originate in supply shortfalls and other special events.

Prices in the United States have been affected heavily in the past several years by a variety of special factors. Disappointing harvests in 1972 -- both here and abroad -- caused a sharp run-up of food prices in 1973. Beginning in the fall of last year, the manipulation of petroleum shipments and prices by oil-exporting countries led to huge increases in the price of gasoline, heating oil, and related products.

Furthermore, a world-wide boom in economic activity during 1972 and 1973 led to a bidding up of prices everywhere. In the United States, larger foreign orders for industrial materials, component parts, and capital equipment added to growing domestic demands. Pressures became particularly intense in the major

materials industries -- such as steel, aluminum, cement, paper -- in which expansion of capacity had been limited in earlier years by low profits and environmental controls.

The impact of world-wide inflation was especially severe in the United States because of the decline in the exchange value of the dollar relative to other currencies. Besides stimulating our export trade, and thereby reinforcing the pressures of domestic demand on available resources, devaluation raised the dollar prices of imported products, and these effects spread through our markets.

More recently, the removal of controls over wages and prices has led to sharp upward adjustments in both our labor and commodity markets.

It has at times been suggested that monetary policy could have prevented these special factors from affecting significantly the average level of wholesale and consumer prices. That may well be true, but the cost of such a policy should not be underestimated. Last year, about 60 per cent of the rise in consumer prices was accounted for by food and fuel; for wholesale prices, the proportion was even higher. To achieve stability in the average price level, it would therefore have been necessary to bring down very sharply the prices of other goods and services.

Prices of many commodities -- particularly farm products and industrial raw materials -- are established in highly competitive markets and are therefore capable of declining as well as rising. The prices of many other commodities and services that make up the gross national product, however, are nowadays rather inflexible in a downward direction, in large part because of the persistent upward push of labor costs and imperfect business competition. For these commodities, significant price declines could be achieved only by drastically restrictive policies -- policies that would lead to widespread bankruptcies and mass unemployment. A monetary policy that sought to offset completely the effects on the average price level of the rising cost of food, petroleum products, and other commodities whose prices were so heavily influenced during the past two years by special factors, would clearly have been undesirable.

Nevertheless, monetary policy must not permit sufficient growth in money and credit supplies to accommodate all of the price increases that are directly or indirectly attributable to special factors. The rise in the price of petroleum, for example, has increased the costs of energy, plastics, petroleum-based chemicals, and other materials. Business firms will endeavor

to pass these higher costs through to consumers. Workers, too, will bargain for larger wage increases, in order to compensate for declines in their real incomes. To the extent that wage increases outrun gains in productivity, business costs -- and ultimately consumer prices -- are driven up. Thus, in addition to their direct effects on prices, special factors may have large and widespread secondary effects on the price level.

A monetary policy that accommodated all of these price increases could result in an endless cost-price spiral and a serious worsening of an already grave inflationary problem. The appropriate course for monetary policy is the middle ground. The price rigidities characteristic of modern industrialized economies must be recognized, but a full pass-through of all the price effects stemming from special factors must not be permitted.

The middle course of policy we have adopted has resulted in a growth rate of the narrowly-defined money supply -- currency and demand deposits -- of about 6 per cent during the past 12 months. This rate of growth is still too high for stability of average prices over the longer term. But moderation in the growth rate of money and credit supplies must be achieved

gradually to avoid upsetting effects on the real economy. This is particularly true now, when price-cost relations are seriously distorted.

I turn now to Chairman Patman's third question, which relates to the positive elements and the risks involved in monetizing deficit spending. The simple fact is that financing Federal deficits by printing money involves risks, and the risks are grave.

Fortunately, since 1951, monetary policy in this country has not been conducted with an eye to providing a ready market for Treasury securities, or for financing Federal deficits. Considerations of this kind were an objective of Federal Reserve policy during World War II, when Treasury borrowing proceeded on an unprecedented scale in relation to the size of our economy. I doubt if such a policy was warranted even under war-time circumstances, and its continuation in the years immediately after the war was a very serious mistake. It led to excessive increases in borrowing by private firms, consumers, and State and local governments, and thus fueled the subsequent inflation.

The dangers inherent in this situation became acutely evident during the Korean War, when Federal deficits once again threatened. With the aid of prodding by the Congress,



particularly by Senator Douglas, the Federal Reserve and the Treasury resolved their disagreements, and monetary policy returned to its traditional role of regulating the supply of money and credit in the interest of economic stability.

Since then, the Treasury has financed its deficits at prevailing market interest rates in competition with other borrowers.

During periods of large Treasury financings, the Federal Reserve follows the practice of maintaining "even-keel" in the money market -- that is, we refrain from taking overt actions that market participants might interpret as a change in monetary policy. On some occasions, therefore, the maintenance of "even-keel" has delayed the timing of changes in monetary policy. Treasury financing operations thus pose problems for monetary policy, particularly when they are large and frequent.

Federal deficit financing becomes a major source of economic and financial instability when it occurs during periods of high economic activity, as it has in recent years. The huge Federal deficits of the past decade have added enormously to aggregate demand for goods and services, and have thus been directly responsible for upward pressures on the price level. Heavy borrowing by the Federal sector has also been an important

contributing factor to the persistent rise in interest rates, and to the strains that have at times developed in money and capital markets. Worse still, continuation of budget deficits has tended to undermine the confidence of the public in the capacity of our government to deal with inflation.

If the present inflationary problem is to be solved, and interest rates brought down to reasonable levels, the Federal budget must be brought into better balance. This is the most important single step that could be taken to restore the confidence of people in their own and our nation's economic future.

Let me turn, next, to the Committee's fourth question, dealing with the benefits and risks of the Federal Reserve's fighting money-market fires.

As this Committee well knows, the cardinal aim of monetary policy is maintenance of a financial environment in which our national objectives of full employment and price stability can be realized. For the most part, this responsibility is best achieved by striving for appropriate growth rates of the monetary aggregates, and letting financial markets take care of themselves.

The appropriate monetary growth rates will vary with economic conditions. They are apt to be higher during periods of economic weakness, when aggregate spending is in need of stimulus, than when the economy is booming and inflationary tendencies threaten economic stability. Special circumstances may, however, call for monetary growth rates that deviate from this general rule. For example, as noted in my response to the second question, the special factors giving rise to extraordinary price pressures during the past year or two have required toleration of a monetary growth rate that has been relatively high by historical standards.

There are times when responsibility for maintaining financial and economic stability requires the Federal Reserve to focus attention primarily on factors other than growth in the money supply or bank credit. The oldest and most traditional function of a central bank is to act as a lender of last resort -- that is, to provide liquidity when dislocation of financial markets threatens serious damage to the economy. Acting in this capacity, the Federal Reserve in the summer of 1970 warded off a developing liquidity crisis in the commercial paper market. This year, difficulties encountered by a large commercial bank led

to rumors of widespread illiquidity of the commercial banking system. These concerns were reduced by timely Federal Reserve action at the discount window.

It so happens that in neither of these instances did the Federal Reserve's intervention result in a significant deviation of the monetary aggregates from desired growth rates. But let there be no mistake about our determination to deal with financial troubles. In the future, as in the past, we will surely not stand aloof and permit a crisis to develop out of devotion to this or that preconceived growth rate of the money supply.

The responsibility of the Federal Reserve for conditions in the money and capital markets goes beyond its historic function to act as lender of last resort. Monetary policies need to be implemented, I believe, in ways that avoid large and erratic fluctuations in interest rates and money market conditions.

From one month to the next, the public's demand for money is subject to variations that are usually of a short-run nature. For example, a large tax refund, a retroactive increase in social security benefit payments, or a sizable disbursement by the Treasury of revenue-sharing funds may produce a temporary bulge in the demand for cash balances. If the Federal

Reserve tried to maintain a rigid monetary growth rate in the face of such developments, interest rates could fluctuate widely, and to no good end. The costs of financial intermediation would be increased, and the course of monetary policy might be misinterpreted. To avoid these harmful effects, the Federal Reserve seeks to achieve desired growth rates of money and credit over relatively long periods. Experience over the past two decades suggests that even an abnormally large or abnormally small rate of growth of the money stock over a period of 6 months or so has a negligible effect on the course of the economy -- provided it is subsequently offset.

We recognize, of course, that too much attention to preventing short-run fluctuations in interest rates could inadvertently cause the growth rate of money or credit to drift away from what is appropriate for the longer run. To guard against this possibility, the Federal Reserve in early 1972 introduced a new set of procedures for implementing monetary policy. These procedures focus more attention on provision of bank reserves through open market operations at a pace consistent with desired growth rates of monetary and banking aggregates.

The new procedures have been helpful, but numerous problems of monetary control still remain. For example, a substantial part of the money supply is in the form of deposits at nonmember banks. As a consequence of this and other factors, there is considerable slippage between the supply of bank reserves controlled by the Federal Reserve and the nation's money supply. Monetary control is therefore less precise than it could or should be. I would once again urge the Congress to correct this defect by extending the Federal Reserve's power over reserve requirements to all commercial banks.

Let me turn next to Chairman Patman's fifth question, which deals with the relationship that interest rates, the money supply, and the rate of inflation bear to one another.

Most interest rates in the United States are now at the highest levels in our history. There are some who believe that restrictive monetary and credit policies are responsible for this state of affairs. This view is erroneous. The basic reason why interest rates have risen to their present level is the accelerating pace of price advances over the past decade, so that we now find ourselves in the midst of a two-digit inflation.

Historical evidence -- from other countries as well as our own -- indicates beyond any doubt that inflation and high interest rates go together. The reasons are not hard to understand. In most countries throughout the Western world, inflationary expectations have become deeply imbedded in the calculations of lenders and borrowers. Lenders now reckon that loans will probably be repaid in dollars of lesser value, and they therefore hold out for nominal rates of interest high enough to assure them a reasonable real rate of return. Borrowers, on their part, are less resistant to rising costs of credit when they anticipate repayment in cheaper dollars.

Interest rates at anything like present levels are deplorable. They cause hardships to individuals and pose a threat to the viability of some of our industries and financial institutions. But we cannot realistically expect any lasting decline in the level of interest rates until inflation is brought under control.

History also indicates that high rates of inflation are typically accompanied by high growth rates in supplies of money and credit. But inflationary tendencies and monetary expansion are not as closely related as is sometimes imagined.

For example, the econometric model of the St. Louis Federal Reserve Bank, which assigns a major role to growth of the money stock in movements of the general price level, has seriously underestimated the rate of inflation since the beginning of 1973. Simulations of the model, using the actual growth rates of the money supply since the first quarter of 1972, suggest that the rate of inflation during the past two quarters should have been a mere 3-1/2 per cent. Apparently, special factors -- such as I mentioned previously -- have been at work.

Inflationary processes are characterized by rising turnover rates of the existing stock of money as well as by relatively high rates of monetary expansion. Recent experience in the United States illustrates this fact. Over the past ten years, the average annual increase in the money stock has been about 6 per cent -- a higher rate than in the previous decade. Since 1964, however, the income velocity of money -- that is, the ratio of gross national product to the money stock -- has risen at an average annual rate of about 2-1/2 per cent, thus contributing importantly to the inflationary problem.



The role of more rapid monetary turnover rates in inflationary processes warns against assuming any simple causal relation between monetary expansion and the rate of inflation either during long or short periods. Excessive increases in money and credit can be an initiating source of excess demand and a soaring price level. But the initiating force may primarily lie elsewhere, as has been the case in the inflation from which this country is now suffering.

The current inflationary problem emerged in the middle 1960's when our government was pursuing a dangerously expansive fiscal policy. Massive tax reductions occurred in 1964 and the first half of 1965, and they were immediately followed by an explosion of Federal spending. The propensity of Federal expenditures to outrun the growth of revenues has continued into the 1970's. In the last five fiscal years, total Federal debt -- including the obligations of the Federal credit agencies -- has risen by more than \$100 billion, a larger increase than in the previous 24 fiscal years.

Our underlying inflationary problem, I believe, stems in very large part from loose fiscal policies, but it has been greatly aggravated during the past year or two by the special

factors mentioned earlier. From a purely theoretical point of view, it would have been possible for monetary policy to offset the influence that lax fiscal policies and the special factors have exerted on the general level of prices. One may therefore argue that relatively high rates of monetary expansion have been a permissive factor in the accelerated pace of inflation. I have no quarrel with this view. But an effort to use harsh policies of monetary restraint to offset the exceptionally powerful inflationary forces of recent years would have caused serious financial disorder and economic dislocation. That would not have been a sensible course for monetary policy.

The last question put to me deals with how monetary policy should be used to check inflation and bring interest rates down to reasonable levels.

The principal objective of monetary policy since late 1972 has been to combat the inflationary forces threatening our economy. To this end, supplies of money and credit have been restricted at a time when credit demands were booming. Inevitably, therefore, interest rates have risen. This unhappy consequence has led some observers to conclude that restrictive monetary policies are counterproductive -- because rising interest rates

are an added cost to businesses and thus may result in still higher prices.

There is a grain of truth in this argument, but no more than that. For most businesses, interest costs are only a small fraction of total operating expenses. The direct effects of a restrictive monetary policy on costs and prices are therefore small. The indirect effects of a restrictive monetary policy on prices are far more important. When growth in supplies of money and credit is restrained, some business firms and consumers are discouraged by the high cost of credit from carrying through their plans to spend; others find it more difficult to obtain credit and therefore trim their spending; still others, reckoning that monetary restraint will cool off aggregate demand, curtail their outlays for goods and services even though they do not depend on the credit markets for spendable funds. In all these ways, a restrictive monetary policy helps to moderate aggregate spending and thus to reduce inflationary pressures.

In order to bring interest rates down to reasonable levels, we shall need to stay with a moderately restrictive monetary policy long enough to let the fires of inflation burn themselves out.

Progress can still be made this year in slowing the rate of price increase, and it is urgent that we do so. Inflation has been having debilitating effects on the purchasing power of consumers, on the efficiency of business enterprises, and on the condition of financial markets. The patience of the American people is wearing thin. Our social and political institutions cannot indefinitely withstand a continuation of the current inflationary spiral.

We must face squarely the magnitude of the task that lies ahead. A return to price stability will require a national commitment to fight inflation this year and in the years to come. Monetary policy must play a key role in this endeavor, and we in the Federal Reserve recognize that fact. We are determined to reduce over time the rate of monetary and credit expansion to a pace consistent with a stable price level.

Monetary policy, however, should not be relied upon exclusively in the fight against inflation. Fiscal restraint is also urgently needed. Strenuous efforts should be made to pare Federal budget expenditures, thus eliminating the deficit that seems likely in fiscal 1975. The Congress should resist any temptation to stimulate economic activity by a general tax cut or a new public works program. There may be justification

for assistance to particular industries -- such as housing -- that are especially hard hit by a policy of monetary restraint. An expanded public-service employment program may also be needed if unemployment rises further. But government should not try to compensate fully for all the inconvenience or actual hardship that may ensue from its struggle against inflation. Public policy must not negate with one hand what it is doing with the other.

There are other actions that may be of some help in speeding the return to general price stability. For example, limited intervention in wage and price developments in pace-setting industries may result in considerable improvement of wage and price performance. I would urge the Congress to re-establish the Cost of Living Council and to empower it, as the need arises, to appoint ad hoc review boards that could delay wage and price increases in key industries, hold hearings, make recommendations, monitor results, issue reports, and thus bring the force of public opinion to bear on wage and price changes that appear to involve an abuse of economic power. Encouragement to capital investment by revising the structure of tax revenues may also be helpful, as would other efforts to

enlarge our supply potential. For example, minimum wage laws could be modified to increase job opportunities for teenagers, and reforms are still needed to eliminate restrictive policies in the private sector -- such as featherbedding and outdated building codes.

A national effort to end inflation requires explicit recognition of general price stability as a primary objective of public policy. This might best be done promptly through a concurrent resolution by the Congress, to be followed later by an appropriate amendment to the Employment Act of 1946. Such actions would heighten the resolve of the Congress and the Executive to weigh carefully the inflationary implications of all new programs and policies, including those that add to private costs as well as those that raise Federal expenditures. And they would signal to our people, and to nations around the world, that the United States firmly intends to restore the conditions essential to a stable and lasting prosperity.

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