Current Policy and the Future Capital Stock

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by

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I am pleased to appear at this first seminar of the Task Force on Capital Needs. It is appropriate the Task Force has chosen to consider long-term problems at the very beginning of its work. The economic problems that vex us in areas as diverse as energy, transportation, inflation and unemployment are to a considerable extent problems that we have created by our neglect of the long-term consequences of actions taken to solve short-term problems.

During your seminars and discussions in the next few weeks you will be advised, frequently, about the importance of stimulating the economy. You will be presented with arguments and statistics suggesting that you can get something for nothing -- more output, more employment, more economic well being, more capital and more consumption by having the Federal Reserve print more money now. For a short-time that argument if accepted will appear to be correct. Increased monetary expansion now will raise employment next year but only at the cost of more inflation in 1977 and later years.

It is not accident or chance that you begin these seminars at a time of high unemployment and in the midst of the longest, most severe peacetime inflation in the history of the country. Neither is it an accident that after fifteen years of seeking short-term solutions to the problem of inflation and unemployment, we have more of each. Nor
is it an accident that Congress is testing two new arrangements after a
decade of inflation. We have had an expensive education, but I hope we
have learned well that next year's good news about employment is too often
followed by bad news about inflation.

The two principal lessons to be learned from the failures of the past
decade are:

(1) there has been inadequate control of the government budget
by Congress and the Executive;

(2) there has been inadequate control of the stock of money by
the Federal Reserve.

An experiment is now underway to control the budget more effectively
than in the past. Control of the budget is important, but it is not
sufficient by itself to prevent alternating periods of inflation and
unemployment or to prevent alternating periods of high and low inflation
and high and low unemployment.

Budget deficits are financed initially by increasing the outstanding
government debt. The Treasury sells bonds, notes or bills on the
market. The sales raise interest rates. The Federal Reserve seeks
to control interest rates, particularly short-term rates, so it buys
bills, notes or bonds from the market expanding the money stock. In this
way, the deficit is financed; the money stock grows more than is
consistent with price stability, and prices rise.

Congress has established procedures that may bring an end to this
process. The Federal Reserve has been instructed to control the growth
of money and to inform Congress and the country of the planned growth rate
of money for the year.
This is a potentially significant step. The Federal Reserve must focus on longer-term objectives. To achieve these objectives, the Federal Reserve will be forced to establish procedures that are capable of achieving the announced growth rate of money. It will be forced to abandon historic concern for short-term interest rates and, at last, establish procedures consistent with its responsibility to achieve and maintain high employment without inflation.

The potential importance of the Congressional Budget Committees and monetary control will be realized if these new arrangements become a set of rules guiding our future action and sounding early warning of impending problems. Long ago we abandoned the set of rules that firmly guided our policies. These rules were commitments to a balanced budget and to the gold standard. While the rules were observed they prevented inflation but at a cost in unemployment that we hoped to lessen. It was, I believe, appropriate to abandon the old rules, but it was -- we now see with hindsight -- incorrect to substitute unlimited discretion. Our new or nascent procedures may provide the proper combination of budget and monetary control that reduces inflation while maintaining high employment.

The Current Problem

We are, currently, far away from high employment and stable prices. Our problem is to find the means of achieving high employment as rapidly as is consistent with reducing inflation in the future. What we do now -- in 1975 and early 1976 -- will determine to a considerable degree the inflation we experience in 1977 and 1978.
Some urge a rapid rate of monetary expansion now to be followed by a slower rate of monetary expansion once recovery is achieved or underway. Using various models of the economy that claim to predict quarterly changes they conclude that strong stimulus applied now will produce more employment but little more inflation.

I believe not only that this advice is wrong but that it is a cause of many of our present difficulties. Those difficulties are to a considerable extent the result of previous attempts to manage the economy according to forecasts that look one, two or four quarters ahead.

Our experience during the past fifteen years shows that a three year average rate of monetary growth provides a forecast of the rate of price increase in the following year. Table 1 shows these data. The only exceptionally bad forecast is 1974 when the much discussed problems of oil, devaluation and the shortages following the end of price controls added considerably to the rate of price increase that year.

[Insert Table 1 here]

If we increase the rate of monetary expansion to fifteen per cent this year, as some have suggested we raise the three year average rate of monetary expansion above nine per cent and can expect inflation to rise in 1976 toward nine percent and to remain high or rise again in 1977.

The more appropriate policy is to let inflation subside by maintaining monetary growth at a 5 to 6 per cent rate of increase this year and next. That policy reduces the rate of inflation toward 4-1/2 per cent in 1977.
Table 1

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<th>Bond</th>
<th>Industry New An Real Rate</th>
<th>Interest</th>
<th>Less 1% CoI (1)</th>
<th>Price Change</th>
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</table>

Source: BCD, Salmon Brothers

From Salmon Bros. 1969-69, 5 1/2% is currently available AA $1,750

1/ Denotes for 3/4 product

2/ Does not include current year

* 2 quarters

Table 1
Budget Policy

Monetary policy should not operate alone. The monetary policy that I have recommended should be accompanied by tax reduction and a reduction in the rate of increase of government spending.

The projected budget deficit and the increase in money that I have recommended imply a very large increase of government debt outstanding. Increases in debt of this magnitude raise market interest rates and discourage private capital formation. The net effect of a large budget deficit during recession is a higher level of income and employment. Saving rises and partly finances the government debt issued to finance the deficit. The deficit also raises interest rates and reduces private investment spending.

In Table 1, I have used the average rate of monetary expansion in the previous three years as an estimate of the anticipated rate of inflation. The "real" rate of interest on corporate bonds is shown in column (6). This is an estimate of the rate bond purchasers expected to receive on the average after adjustment for anticipated inflation. During the five years of largest government borrowing, the computed real rate of interest is 3.16 per cent; during the five years of lowest government borrowing or debt reduction, the computed real rate of interest is 2.46 per cent.

I caution you to consider these numbers as no more than crude indications. Many factors affect real rates of interest, and the summary I have given is at most suggestive. The point to be emphasized is that there is evidence in these numbers that is consistent with the view that large deficits financed by selling debt reduce private investment.
What Should be Done?

Is there a way out of the problem of inflation and unemployment that does not bring either more inflation or more unemployment? If we require a solution to both problems in less than three or four years I believe the answer is no. We do not know how to get from our present position to a position of full employment without inflation quickly. We may do better, but we cannot expect to do better than reducing inflation gradually while reducing unemployment gradually over the next few years.

To achieve the modest goals of full employment without inflation at the end of the decade we should adopt a monetary and fiscal stance that:

1. Maintains the rate of monetary growth at about 5-1/2 percent for the next six or twelve months and gradually reduces the rate of monetary expansion as the unemployment rate falls;

2. Reduces taxes so as to stimulate private capital formation and the financing of private capital formation;

3. Reduces the growth rate of government spending and the size of government deficit that must be financed by issuing debt;


These suggestions or recommendations encourage you to look ahead to the end of the decade, not to the end of the year or to the middle of next year. "Stop and go" and "fine tuning" have not worked because we do not know how to make them work.

We have adopted procedures that if properly applied will restore stability. I hope you will adapt them to that end.