A Framework for Monetary Policy

Author(s): Paul A. Volcker

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A FRAMEWORK FOR MONETARY POLICY*

Paul A. Volcker

Chairman, Board of Governors
Federal Reserve System

Prosperity and growth can only be assured in a framework of greater price stability, but for too many years the trend has been in the other direction. Many people have come to accept inflation as the "norm," and, in their personal and business decisions, have even come to "count on" its continuing.

At the same time, it is evident that these years of inflation have culminated in a period of slow growth, sagging productivity, and higher unemployment–and that there has been a close connection between the rising inflation and poor economic performance. That is a basic reason why I believe that we, as a nation, must give priority to restoring price stability to our economy. That effort has placed, and will continue to place, a heavy responsibility on monetary policy and the Federal Reserve. More specifically, there will be a continuing need to restrain growth in money and credit to amounts consistent with the needs of the economy at stable prices. I would like to spell out a little more fully some of the implications of that effort for the health of our economy.

With inflation so deeply ingrained in thinking and behavior–so embedded in pricing and wage policies, in financing patterns, and in investment behavior–the notion of a quick and easy victory seems to me an illusion. The trend of monetary and credit growth has been reduced for more than two years. We can point to signs of progress against inflation. But we are also compelled to report that, outside the area of sensitive commodity prices, most indexes of prices and wages show rates of increase so far this year only slightly below last year's pace. Moreover, some of the progress has come in areas in which the relief may only be temporary–bountiful harvests have held down food prices, and surpluses in oil markets led to actual declines in gasoline prices during the summer and fall. Lower rates of wage increases have been largely limited to the manufacturing sector.

More broadly, we need to be able to sustain progress toward price stability in a context of balanced growth, not of recession and excessive

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unemployment. As you well know, the intense pressures on financial markets during much of 1980 and 1981 have been reflected in heavy stress on credit-sensitive areas of the economy, such as homebuilding, farming, automobiles, and small businesses. Strains on the financial structure, most notably in the thrift industry, have intensified. Over recent weeks, economic activity generally has turned down. As it has done so, interest rates have fallen sharply, with some short-term rates as much as 6 percent below the peaks of the summer. That respite is welcome, and should help cushion the recent decline in business. But a lasting solution to our inflationary and financial problems plainly cannot be dependent on "special factors" or a slack, underemployed economy.

In short, a fair appraisal of the current situation suggests that the battle against inflation has been fairly joined, but it is far from over. Success will be dependent on sustaining consistent monetary, fiscal, and other policies. As we do so, we can look forward to fundamental changes in expectations and in behavior that will, in turn, reduce cost pressures, enhance productivity, and unwind the inflationary process. In those circumstances, we could indeed look forward to sustained growth for years ahead.

The current inflation, as I see it, has been with us so long that it can be said to have a "history." And Santayana's dictum—that those who would not remember the past are condemned to repeat it—is as apt in this policy area as others.

After the searing experience of the Great Depression and with the post-World War II emphasis on growth and employment, policymakers came to accept the proposition that inflation was a lesser evil—that, indeed, it was both appropriate and possible to "trade off" more growth and employment against inflation. When inflation was low, it didn't seem very dangerous. Moreover, so long as inflation was not expected to continue, it may well have acted as a kind of mild "pep pill." But over time, our experience with inflation has been different. As inflation is sustained and anticipated, it undermines normal incentives to produce, to save, and to invest; growth in real income and employment deteriorates.

We have learned, too, that once inflation is built into behavior and expectations, it becomes increasingly difficult to reverse; left to its own devices, it tends to accelerate. The history of this inflation has been marked by repeated attempts to bring it under control. The lack of success of the earlier efforts was not entirely, or even largely, a function of faulty policy conception. Rather, those efforts failed when the commitment to restraint wavered or vanished as they appeared to conflict with other objectives. In the end, we were left with both more inflation and less growth. The failure to carry through at critical junctures conveyed an unfortunate lesson of its own—to businessmen, to financial markets, and the public at large—a deep-rooted skepticism that price stability could or would be restored.

Partly because of the recurrent efforts to deal with it, the inflationary pattern of the last fifteen years has not been anything like a simple straight line on the charts. Rather, there has been a pattern of surges and ebbs, but with a clear ratcheting to higher levels. Each new wave of inflation brought a new peak; each upswing was followed by some easing in the rate of price increase, but it was never reduced to the previous low point.

This experience is new to American history. When we have had severe inflation before, it was typically during wartime. Those episodes were relatively brief, and, except after World War II, they were followed by a period of price decline. In this country, unlike many others, there has been no collective memory or fear of really severe, sustained inflation; our attitudes and institutions were built on a presumption of price stability and low interest rates.

The current inflation started relatively slowly. From 1965 to 1970, when the economic stimulus from the Vietnam War was heaped on an economy already operating at high capacity rates, consumer price increases went from 1½ to nearly 6 percent, but then subsided to 3½ percent by 1972. Even that was considered disturbing, and, for a time, we resorted to the crutch of wage and price controls. But with the benefit of hindsight, the country did not sustain the financial discipline necessary to keep inflation in check. In the face of a worldwide economic boom and poor harvests, inflation accelerated. The first "oil shock" soon gravely aggravated the situation, and we had our first taste of double-digit inflation since the aftermath of World War II. Even the deepest postwar recession in 1974 and 1975 left the inflation rate close to 6 percent. By 1977 prices began to accelerate again and last year rose by more than 13 percent, as measured by the consumer price index.

In an economy like ours, there is a great deal of inertia in wage and price trends. It took time for the first inflationary impulses to be reflected in multiyear labor contracts, or to ripple through to prices of consumer goods and services. It was easy to fool ourselves for a while—budgetary and monetary restraint didn't seem so urgent when wage and price trends were showing relatively little change. Moreover, while interest rates tended to rise, borrowers and lenders for a time continued to act on the presumption that inflation would in time subside. During much of the 1970s, interest rates—even before taxes—provided little or no return after inflation.

But the same inertia and expectational factors tend to keep inflation going—or to accelerate it—once the process is fairly under way and sustained for years. Workers naturally aim for, and expect, wage gains that will keep up with past inflation and protect them from future price increases. Firms try to set prices above anticipated rising costs, and they sometimes succeed. Lenders begin to demand real returns, and borrowers are willing to pay much higher interest rates as they anticipate higher prices later for the things they buy.

The harsh fact is that our present inflation—looking at both its duration and extent—is the most severe in our history since the Continental Dollar was inflated out of existence. Consumer prices have risen more than 160 percent over a span of fifteen years. Is it any wonder that so many, from the average citizen to the Wall Street investor, have sought to protect themselves from rising prices, have often become more interested in speculation than in production, and want to be "shown" conclusively our commitment to a sustained anti-inflation policy?

Nowhere have the demands for inflation "premiums" been more characteristic than in financial markets and interest rates. Instead of the negative or low interest rates in real terms that have characterized most past inflationary periods, interest rates have in fact moved well above the current inflation rate. Even in recent months, as short-term rates began to fall substantially, long-term rates continued to rise for a while to new peaks. In the past week or two, those interest rates have fallen sharply, but they remain extremely high historically.

The most recent developments bring us to a new stage in the fight on inflation. Weakening in business activity is being reflected in softening private credit demands. Interest rates—as I just noted—have been declining, and further reductions in the inflation rate would be a natural response to economic slack. But a temporary respite in the face of economic adversity won't be good enough. We need to build policies that will change the inflationary *trend* for the better so that progress toward price stability can be compatible with growth—indeed, will help sustain that needed growth.

Monetary policy is central to that effort. Economic theory and historical experience alike support the proposition that inflation will be brought under control, and stability maintained, only if we restrain the growth of money and credit over time to amounts consistent with the potential growth of real output at stable prices.

As many of you know, two years ago the Federal Reserve adopted new operating procedures in order to focus its control more directly on growth of money. These procedures emphasize control on growth of bank reserves, which in turn are related to growth in money and credit.

In concept, that sounds simple and almost mechanical. In practice, it is neither.

In a rapidly changing institutional setting, the definition of money itself can be slippery, and there will always be debate about which of several available measures of money is the most reliable indicator and about how the latest data should be interpreted. The statistics bounce around from week to week or month to month in the best of circumstances, and there is slippage between our control of reserves and the money supply by any definition. And, in the short run, more aggressive control of money can be reflected in more interest rate and exchange rate volatility, which presents problems of its own.

We do not have the time to explore all those operational questions today; in the end, we cannot escape matters of judgment. But, standing back and viewing the evidence over a reasonable period of time, I would assert that our actions reflect our stated intention—we have slowed down the growth of money and credit.

There are some who would assert that monetary restraint is not only necessary to restore price stability, but that such restraint is the end of the story so far as inflation is concerned. That may be a nice textbook theorem, but it is not a proposition that seems to me applicable to the world in which we live. We should be, and we are, interested in finding ways to ease the process of disinflation, without unnecessary stresses on the economy as a whole, on particular sectors, or on financial markets or institutions. The need for a sustained approach implies the need for a balanced approach.

Monetary policy is the responsibility of the Federal Reserve. But financial markets and the economy as a whole are affected not just by monetary policy, but by the interaction of all policies.

The clear opportunity exists to relieve the pressures in financial markets arising from actual and projected federal budget deficits. A few months ago, the Administration and the Congress moved toward a far-reaching fiscal plan designed to reverse the ominous trends of the past decade—higher effective tax rates, higher expenditures relative to the size of the economy, and persistent deficits. This year federal tax receipts will be more than 21 percent of GNP, a peacetime record, and in the absence of tax law change were headed still higher. Expenditures were, of course, still higher.

A significant reduction in federal taxes relative to national income, one major element of that plan, has already been enacted; the tax take relative to GNP should be reduced to about 19 percent by 1984. Over the course of the next couple of years, the tax cuts to individuals and businesses have the potential to improve incentives for investment and savings.

There is a danger, however, that congestion and pressures in financial markets could counter the beneficial effects. The net fiscal position of the government, that is, the burden on the financial markets from the federal deficit, will have a direct bearing on that question.

In other words, both the expenditure and tax side of the budgetary equation are relevant. The Administration and the Congress recognized that reality by undertaking a sizable reduction in outlays when the tax bill was enacted. The size and range of that effort was unprecedented in my experience in Washington. But it is equally true that, in the perspective of the huge tax cuts, the defense program, and the inexorable rise in so-called entitlement programs, those cuts fall far short of what would be needed to balance the budget in any reasonable time frame. Indeed, as things stand, action will be required to prevent the deficit from rising in absolute terms or relative to GNP. Doubts on that score have already had a profound effect on financial markets. While interest rates have recently been declining, the stubbornly high level of long-term rates is influenced by concerns of heavy federal financing extending into a period of business expansion.

All the talk about balancing the budget in a particular time frame can be rife with confusion unless we specify the economic conditions in which the budget can and should be balanced. The significance of a federal deficit in any given year depends on the general state of the economy and a number of more particular factors, including the potential for national savings and competing demands for money and credit in the private sector. For instance, in periods when saving is relatively high or when demand is slack for business credit or in the housing industry, the Treasury may be able to sell securities without "crowding out" investment activity. It may not be possible or desirable to offset temporary losses of revenue as a result of sluggish economic activity. Put more generally, purely cyclical fluctuations in the budget deficit are not at the root of the problem, and a substantial part of the fiscal 1982 deficit will be cyclical.

What is a problem is that, in good years as well as bad, deficits have persisted; we have a structural, as well as a cyclical, deficit. And those deficits work directly against our objectives when they absorb funds that could and would be used to meet our investment and housing needs. In the last fiscal year, the federal government preempted close to $80 billion to finance the deficit and off-budget activities, an amount close to half of the net available savings in the nation. That money was preempted at a time when high interest rates were holding back business investment and homebuying.

The Federal Reserve cannot deal effectively with financial market pressures stemming from structural deficits in good business years. If we were to push more money and credit into the system than is consistent with our longer-run objectives, it would not be long before any temporary relief to the market would be swept away by new—and in those circumstances legitimate—concerns about inflation.

The need, instead, is to make progress on both sides of the savings-deficit relationship. Changes in the tax code, lower levels of inflation, and positive real interest rates should all work toward increasing our chronically low savings rate. But savings patterns, judged historically, are not likely to shift dramatically, and we should not count on that alone to do the job. What we need to do is face up to the need to cut, and eliminate, the structural deficit at the earliest opportunity. I cannot avoid one further conclusion—if spending trends cannot be brought into line with our prospective capacity to generate revenues with present taxes, then we cannot shrink from considering new revenue sources.

I have taken a good deal of time to explain what you should expect from monetary and fiscal policies in the battle against inflation. A reduced deficit over time and return to budgetary balance—in a good business year—is critical to avoiding endemic pressures in financial markets and to sustained growth in the private economy. As for the Federal Reserve, I want to assure you that our commitment is firm: we need to persist in the policies of financial discipline that are now in place.

I also want to acknowledge what is so evident today. After years of inflation, the transition to greater price stability is not a simple painless process. The speed of that transition depends in considerable part on the way individuals and businesses respond to what is already happening, and to the policies in place.

Individually, we always want higher real income, larger profit margins, or more leisure. And, in a well-functioning, growing economy we can have all those things. The paradox is that those results will come more quickly and surely to the extent that we collectively restrain our demands for higher prices and for larger wages.

We cannot expect policies to be successful that ask our citizens voluntarily to refrain from action they consider contrary to their individual interests. We can point out, however, that there will not be enough money and credit to finance sustained inflation, and that jobs and companies are risked when costs get out of line. We can emphasize that ultimately only production and productivity can provide higher incomes. And we can reasonably claim that, as the trend of costs and prices subsides, we will have laid a firm foundation for sustained growth and low interest rates.

From my perspective, there are strong grounds for optimism. I sense a strong determination among the American people that, after years of vacillation, the time has come to deal decisively with inflation. There is a realistic awareness that the failure to face up to the challenge now would only leave us in a more difficult situation. The battle against inflation has been fairly joined, and we can see signs of progress. We must carry through until the battle is won.