

“Money, Economic Activity, Interest Rates: The Outlook.” *Savings and Loan Annals* 1970, pp. 60-68. Chicago: United States Savings and Loan League, 1971.

I want to do two things today: first, to summarize the outlook for the economy, for prices and for interest rates; and then to go a little deeper into some of the questions that underlie today's relations, in particular the relation between inflation, on the one hand, and interest rates, on the other. Now is a good time to take a fresh look at the outlook for the economy because we are just past the election. During an election campaign, the economic outlook becomes part of the campaign and people from both parties interpret the outlook in light of the political situation. As a result, before an election there are great outcries about the state of the economy—not all of which can be regarded as completely disinterested. Now that the election is over, we have a reprieve; the next big election is two years from now. It is a shame, in a way, that our economic outlook and activity should have to be so dominated by the election. When and if we achieve the good financial society, it will be one in which the economy flows on smoothly without these biennial cycles of political concern.

Where are we in the economy? In my opinion, we are at the end of a very mild recession. Why did we have the recession? We had that recession because of the inflation that had been allowed to occur between 1964 and 1968 and 1969. That inflation moved from a situation in which prices were rising at something like 2% a year to a situation in which prices are rising at something like 7% a year.

In connection with the political aspects of the election, it is always amusing how small the relation is between the images that people have and the actual facts. In the years of the Johnson Administration an inflation emerged in which stock market prices hit an all-time high, in which

financial institution and corporate profits went up tremendously. On the other hand, it was a period during which the take-home pay of the ordinary working man, after allowing for price rise and higher taxes, went down. The period since the Republicans have been in has been one of almost unmitigated gloom on Wall Street, of sharply declining corporate profits and of rising real wages. Appearances are not always what they seem.

Policy of Monetary Restraint Overdone

The rapid inflation either had to be continued or something had to be done to stop it. One of the lessons we know from history is that there has never been an end to inflation without a period of slowdown. It is even harder to stop an inflation without a slowdown than it is to have a binge without a hangover. In order to stop the inflation, in December 1968 the Federal Reserve Board moved to a policy of monetary restraint. In my view, in the first year that policy was overdone. The restraint was severe. Restraint was needed; the direction was right, and it was the only way in which it is possible to stop an inflation. It is not possible to stop an inflation without a slowdown because, in order to have producers trim their prices or raise their prices by smaller amounts, for workers to take smaller increases in pay, there must be a situation which is to some extent a buyer's, rather than a seller's market. There must be some slack so there is downward pressure on prices and output. Moreover, we know from past experience that whenever we go through this process, the effect is first on output and only later on prices.

That is precisely the pattern that was experienced this time. Monetary restraint started in December 1968. Typically it takes about nine months before such a policy has much effect on the economy. It has an effect on stock markets first. About the third quarter of 1969 the economy started to ease off. Industrial production started to come down. A recession was beginning. To start with, prices kept rising under the inertia of the earlier inflation. In the first quarter of 1970 the rate

of price rise started to taper off. Today, for the past several quarters, we have been seeing a very distinct tapering off of the rate of price rise. Consumer prices were rising at a rate of about 7% a year at their peak; today they are rising at, roughly, 4% a year. That they are still rising is bad but that they are rising less rapidly is all to the good. We are now at the end of a recession that was the result of measures taken to end an inflation. Our present episode is the mildest of the postwar recessions—of the same magnitude as the very mild 1960–1961 recession. Unemployment in 1961 got up to a peak of 7%. So far, the highest point reached is 5.6%.

Where do we go in the next six months? In my opinion, the key to this is the change in monetary policy which occurred in February of this past year. At this time the monetary authorities substituted a policy of moderate expansion in the quantity of money for the earlier policy of, essentially, zero growth. In February, there was a shift from an extremely restrictive policy to a moderately expansionary policy. I shall return later to the question of whether that policy is too expansionary. What are its implications for the next six to nine months? What is going to happen during that time is determined by what has already been done in the realms of fiscal and monetary policy. Once we go beyond six-to-nine months, we have to ask what will happen to policy in the future. That shift in policy in February is just now beginning to have sufficient effects on output and on the economy. These effects have been confused, have been concealed by the General Motors strike which has had a large, temporary effect on the economy. I do not think this is a long-term effect but it does have a temporary effect. I believe we will find that beginning in the third quarter of this year, or maybe in the fourth quarter, the economy started on an expansion. Output will be seen to have started to grow, the economy will be seen to have turned around. I do not expect that growth to be at a very rapid pace.

One of the interesting things about the economy that we know from the past is that if there is a deep recession there will be a rapid expansion afterward. If there is a mild recession, there will be a mild expansion. We will continue to see a tapering off of inflation. The effect of monetary policy comes first on output and employment and only at a later stage on prices. We are still experiencing the effects on the rate of price rise of the greater restraint in monetary policy of last year and the moderate expansion of this year. We can look forward in the next six-to-nine months to a continued tapering off of inflation, coming down from its present 4.5% to somewhere like 3% or 3.5% over that period.

As far as unemployment is concerned, what happens depends not only on whether the economy is rising but also on whether it is rising as fast as the potential to produce. The potential output of the country grows currently at a rate of about 4% per year, thanks to increasing capital investment and increasing population. Until output of the economy grows at 4% a year, the gap widens and unemployment tends to go up. For that reason, as in past recessions, unemployment will be a lagging series, that is to say, it will continue to rise for the next three or four or five or six months, and then as the economy starts reaching a 4% real rate of growth, unemployment will turn around and start coming back down. My expectation is that there will be a peak of unemployment—perhaps somewhere in the neighborhood of 6%—early next year and then there will be a distinct improvement.

To come to interest rates, the short-term interest rates have been coming down very drastically. The discount rate reduction from, 6% to 5¾% is a reflection of that decline in the market rate. It follows the market. It has had no influence on the market and will have no influence on it. Similarly, the cut in the prime rate this morning is a reflection of the decline in the short-term rates, of lower bank demands. I think there will continue for some time to be a reduction in short-term

rates. Long-term interest rates kept going up even after short-term rates had come down, but in the last six months they too have been coming down and I expect they will continue to come down, although slowly.

Next Two Years Harder to Predict

So much then for the next six-to-nine months—a moderate, gradual upturn in the economy, a continued tapering off of inflation and a continued reduction in interest rates. Where to in the next two years? That depends on what is going to happen to economic policy from now on out and is far harder to predict than what is going to happen over the next six months. In economic affairs, as in all other affairs, everyone would like to have his cake and eat it too. Everyone would like a world in which prices of the things he sells are going up and of the things he buys, going down. Everyone would like a world in which there is no inflation, prices are stable, there is full employment. In my opinion, it is entirely possible to have a world in which there is no inflation and there is full employment. I do not believe there is any contradiction between those two objectives. However, you can have that combination only if you are willing to take your time about getting it. The problem is one of patience and not pushing too hard. If you push too hard to expand employment, you can do it, but only in ways that will reawaken inflation and lead you back to higher price growth. On the other hand, if you want to stop the inflation fast, you can do that too—cut down in the growth of the quantity of money—but only at the cost of producing a depressed economy, of increasing unemployment instead of reducing it. The key policy in this area is to walk the narrow path between those two routes—to maintain a moderate expansionary enough posture to enable employment to increase while keeping it sufficiently restrictive not to rekindle inflation. I believe it is possible to follow that path but you cannot be sure that that path will take a prescribed amount of time to take you where you want to go.

In looking forward to the next two years, the significant factor is whether politics will again rear its head. The election of 1972 is approaching, and there will be great pressures on all sides to make 1972 the year in which inflation has been brought down to a reasonable level and in which employment has been raised to a high level. Perhaps we can do it by then but it is by no means clear that we can.

No Inflation, Full Employment Difficult in Prescribed Time

In 1961 unemployment reached a peak of 6% or 7%—some months after the economy had started to turn up. It took five years—until early 1966—before unemployment had been reduced to 4%. That occurred only with the beginning of a rapid acceleration of inflation. Fortunately, this time the rate of unemployment has not gotten up to 7% and does not look as if it will. To make another comparison, take the point in 1962 or 1963 when unemployment reached 6%. How long did it then take to go from 6% unemployment to 4%? It took three years. There have been occasions when unemployment has been reduced much more rapidly; others, where it has been slower. The main point that I want to emphasize is that we cannot be sure of getting both of these objectives simultaneously by the prescribed time.

As election approaches, there will be a strong temptation to step on the accelerator. The reason for that is an expansionary policy has its first effect on output and the effects on prices are delayed. There will be a strong temptation to get the favorable effect on output before the election in the hope that the unfavorable effect in rekindling inflation will come after the election. I hope that this temptation will be avoided but it will take great political courage and restraint to do so. We would be far better off as a nation—all of us—if we stayed with the present game plan which has been working very well. In my opinion, the present rate of monetary expansion is somewhat too high for the long pull.

There are many different definitions for the quantity of money. The quantity of money defined as currency plus demand deposits plus checking deposits has been growing since February at the annual rate of 5%. A broader total—currency plus all commercial bank deposits, omitting the large CDs because of their great fluctuation as the result in changes in Regulation Q plus all time deposits—has been growing at the rate of 9% per year since February. As a temporary matter, to make up for the undue restraint of the prior year those rates are not too high. If those rates were continued at that level, they would, in my opinion, renew inflationary pressures at the end of 1971 and early in 1972. Therefore, I hope that the temptation to step on the accelerator will be resisted and that the Federal Reserve Board will, sometime in the next few months, move toward a more moderate rate of expansion rather than toward an intensified expansion. If it does, the prospect will be for continued tapering off of inflation, with continued decline in interest rate and continued improvement in the economy.

Let me turn now to the relation between inflation and interest rates. Who is responsible for inflation? Everyone blames everyone else. The employer blames the trade union; the trade union blames the profit-seeking employer; both blame the banks and the government. The most widely spread belief about inflation undoubtedly is that it is changes in wages that produce inflation. Newspaper reaction to the GM strike has just brought that out clearly. The headline today reads: “GM pay packet boosts inflation.” In my opinion, that view is totally wrong. The correct headline would be: “Inflation boosts GM pay packet.” That is the inflation of last year.

Wage Rises Not Responsible for Inflation

Most of you probably share the belief that wages are responsible for inflation because that seems so natural, so obvious. That is wrong because of a fallacy of composition. What is true for each person separately is not true for everyone together. It looks to each producer separately as if

he has to raise his prices because the wages he pays went up. You ask why his wages went up. It is because someone else was trying to bid his workers away. His cost increase is due to increases in inflation elsewhere.

Trade unions were just as powerful in the United States from 1961 to 1965 as they were from 1965 to 1969. Yet we did not have inflation from 1961 to 1965, and we did from 1965 to 1969. There were very few trade unions in the Civil War. Trade unions were not very powerful in the first world war. They were extremely powerful in the second world war. But we had the same amount of inflation in all three cases. All over the world, countries with trade unions have had inflation and countries without trade unions have had inflation. Communist countries have had inflation; capitalist countries have had inflation. There is no systematic relation between strong unions and wage increases and inflation. When there is a strong pressure of upward demand, this tends to raise prices and wages. The effect on wages tends to be delayed, particularly on union wages because of long-term contracts. Therefore, even after inflation has started to taper off, as a delayed result of prior inflation, wages continue to rise. The GM settlement—which is a very high settlement—is a consequence of the prior inflation. If we maintain control over the quantity of money and keep down the rate of increase in total aggregate demand, we will see a tapering off in the rise of wages. In fact, we have already seen this. The rate of wage rise now is much smaller than it was a year ago.

Inflation is always a monetary phenomenon. What produces inflation is a most mysterious process but there has never been one which has not been accompanied by an unduly rapid expansion in the quantity of money. The reason for this has been different from time to time. From 1848 to 1860, the United States had inflation. Why? Because of the discovery of gold in California. This increased the quantity of money and caused the inflation. From 1890 to 1913 the world had

inflation. Why? Because of some technical discoveries that rendered it commercially feasible to extract gold from low-grade ore by the cyanide process.

Inflation Today is Produced in Washington

In recent years, the situation is different. The quantity of money is controlled by the government, by our monetary authorities, and as a result today inflation is produced in Washington and made in Washington and cannot be produced or made any place else. Since everyone wants to shift the blame, officials of the Federal Reserve and of the government are prompt to say that inflation is being produced by trade unions, by greedy businessmen. I read in the papers where someone came before you and said that savings and loan associations have a special responsibility to contribute to hold down inflation, that you had to be cautious in your lending policies to be sure that you did not rekindle an inflationary spirit. I believe that is utter nonsense. You should attend to your business which is to make loans as profitably and best you know how with whatever resources you are able to attract. In that activity you have no responsibility to take into account any effects on inflation. Those effects are not your doing. If there is a resumption of inflation, it will be because the monetary authorities have increased the quantity of money too much and that cannot be stopped by you. This goes also for the commercial bankers. Inflation is not produced by irresponsible commercial bankers who make the wrong loans. If commercial bankers can make larger loans, it is because they have larger resources, and this is because the quantity of money has been increased by the monetary authorities.

Credit Is Confused with Money

There is confusion about credit and money—between the asset side of the bank's balance sheet and the liability side. Central bankers have tended to confuse monetary policy with credit. From the point of view of credit, the lending done by commercial bankers is but a small part of a large pool.

You are an equally large part of that credit pool. So are insurance companies. So are private individuals. So is the commercial paper market. So is the bond market. So is the equity market. From the point of view of credit, the Federal Reserve and the commercial banking system have an extremely small share of the whole thing.

With money, the situation is very different. Here the banking system provides essentially all the money. Here the Federal Reserve System and the monetary authorities have effective control over the quantity of money. The crucial role of the central bank is how it affects the liability side of the banks' balances sheets plus the currency, not how it affects credit.

Another reflection of this same confusion between credit and money—and here I am coming to the main point of interest rates—is the widespread belief that tight money in the sense of a slow rate of growth of money means high interest rates and easy money in the sense of a rapid rate in the growth of money means low interest rates. The broad facts run exactly the other way. In what countries in the world are interest rates highest? In Chile, or Brazil, or Argentina, where interest rates will be 50%, 60% or 70% a year. Is that because the quantity of money has been held down? No, you will say, those are countries which have printing money freely. They have rapid inflation; that is why interest rates are high. Alternatively, what countries have low interest rates? Switzerland or Germany which have done a good job of holding down the quantity of money. Consider the experience in the United States. When were interest rates at their very lowest? At the end of the Great Depression, in the middle thirties. Was that because the quantity of money was increased? No. From 1929 to 1933 the quantity of money was reduced by 33%. The fact is that rapid increases in money mean high interest rates, not low interest, rates. Slow increases in money mean low interest rates.

Must Distinguish between Short-, Long-Run

The reason for the confusion is due to two things: the failure to distinguish between money and credit and the failure to distinguish between short-run and long-run effects. The price of money is not the interest rate; the price of money is how much goods and services have to be given up to buy a dollar. When the quantity of money is increased prices are driven up and that reduces the price of money. The interest rate is the price of credit. It is not the price of money. The effect of an increase in the quantity of money on credit is much more complicated because here is the difference between short- and long-run effects. To begin with, when the Federal Reserve increases the quantity of money, it does so by buying bonds and this tends to drive up prices and cause lower interest rates. The initial effect of an increased rate in the growth of the quantity of money is to lower interest rates, but that is only the beginning.

As that growth raises prices and income, it then tends to raise interest rates. Here it is important to recognize the difference between the nominal interest rate in dollars and the real interest rate. If you loaned someone \$100 at 6% a year ago and got \$106 back now, you are just about where you started. That \$106 will now buy about the same amount of goods as \$100 would a year ago. It looks as if you charged 6% interest. You did—in dollars—but in real terms the rate was essentially zero. The real rate of interest is the difference between the nominal rate of interest and the rate of price rise.

Interest Rates Have Been Incredibly Low

We all talk about interest rates having been very high in the last year or two. That is wrong. They have been incredibly low. In a year when prices were rising at a rate of 7%, anyone who was able to borrow at a rate of 8% or 9% was getting a bargain because his real cost was only 1% or 2% or 3%. That is the reason there was such a big capital boom at that time. Credit was cheap in the

sense that the real cost was very low. Those lenders who were restricted by usury laws or credit restraints from raising their interest rates were in a bad position. They could not compete.

Similarly, if the rate of growth of the quantity of money is restrained—as it was in 1969—the first effect is to raise interest rates. After a time this lowers rates. Why have interest rates been going down in the last nine months? The newspapers say that it has been the more moderate monetary policy that has been lowering interest rates. Or they say the reduction in the discount rate today will lower interest rates. That is wrong. Interest rates are coming down now because of the tight money of 1969. The monetary restraint of 1969 produced an economic slowdown which lowered the demand for lendable funds which started the tapering off of inflation. This is the reason that interest rates have been coming down.

Temporarily, the shift to a more rapid rate of monetary growth in February helped hold down interest rates. If it continues, it will have the opposite effect; it will cause a turnabout. If the present rate of monetary expansion produces a rapid expansion in economic activity in the middle of next year, short-term interest rates will reach their trough and start to go up again.

Long-term interest rates are a little more complicated. If you are calculating at what rate to lend for the next five years, you want to estimate what the average rate of inflation will be. As a result, what happens to long-term interest rates depends more than anything else at the moment on what happens to price expectations. The reason long-term interest rates kept going up after short-term rates had started to come down last December was that lenders and borrowers were not persuaded that inflation was beaten. The reason short-term rates have come down so much farther than long-term rates is that lenders and borrowers have much more confidence that inflation is on the way out for the next year or so than they have that it is on the way out for the next five years. I am not saying that is a bad judgment. The political pressure to resume inflation will be enormous.

What Will Happen to Inflation?

If you want to predict what long-term interest rates are going to be doing for the next year or so, ask yourself not whether housing will be booming, but ask yourself what will be happening to inflation. If we succeed in the present policy of bringing inflation back down to a 1% or 2% level by 1972, 1973, or 1974, then long-term interest rates will be headed back down to the level of five, six or seven years ago. If our present success turns out to be temporary and we have a rekindling of inflation with price rises at 5%, we have seen nothing yet as far as long-term interest rates are concerned.

Estimate the rate of price inflation and add about four or five percentage points and that will be the answer. With average inflation of about 5%, long-term interest rates will be about 9% or 10%. With average inflation of 10%, long-term interest rates will be 14% or 15%. This is a very important finding for monetary policy.

I pointed out earlier that the Federal Reserve produced the inflation from 1964 to 1969. Why? Because the Board was following a wrong theory. Its members believed the monetary system operated through interest rates. They produced inflation by trying to keep interest rates down. As a result there have been the highest interest rates in over 100 years. The attempt to hold interest rates down made them much higher than they otherwise would have been. The situation will be the same again. The way to have low interest rates is by stopping inflation. That may require an initial period of higher interest rates.

Fortunately, there has been a drastic change in the understanding of our monetary operations by the Federal Reserve and other central banks. The change from emphasis upon interest rates to emphasis upon the quantity of money is the most hopeful augury for a responsible, steady,

moderately expansive monetary policy over the next few years. With such a policy, I think we can have both stable prices and high employment.