Current Monetary Dilemmas: How Effective Is Orthodoxy in an Unorthodox World?

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As a practitioner of monetary policy, I am fascinated by two widely divergent kinds of advice people are now offering the Fed. What I'd like to talk about for a few minutes today reflects an effort to find my way between these views.

One view is the orthodox one, held by many very savvy and prestigious people, but particularly by money-center bankers, here and abroad. This is the idea that inflation is still the old problem of too much money chasing too few goods. Its solution is still a stiff dose of good old-fashioned monetary discipline, painful as it may be. Paul Volcker's appointment and recent moves by the Fed toward higher interest rates have been well received by people holding this view because they see these developments as confirming their idea of what the Fed should do.

A second view is that the economy is becoming increasingly unorthodox and that in this new environment orthodox measures by the Fed are not effective. People who take this line are a much more varied group than those who hold the orthodox view, and their recommendations are much less definitive.

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For one reason, the unorthodox people are negative about what the Fed can do rather than positive about what it should do. And for another, different individuals have different reasons why the Fed can't be effective. Some of these reasons are:

- Inflation is caused by OPEC.
- Inflation is caused by government deficits.
- Inflation is caused by labor unions.
- Higher interest rates no longer bite.
- Even a recession no longer can solve inflation.
- The whole idea of controlling the economy through the demand side is passé; what is needed is policy to affect the supply side.

So what does the Fed do? Is orthodoxy still effective?

ORTHODOXY

Many economists in recent years have been heard to say, "I'm not a monetarist, but . . . ." You can count me as one of these. I don't follow the monetarist line to the point of holding to an invariable growth rate of money regardless of the effect on interest rates, *but* I certainly believe that money is a basic cause of the inflation we now have and that a slower growth rate is essential in getting rid of inflation. All other efforts to combat inflation will surely fail without monetary discipline. If this puts me in the orthodox camp, I'm happy to be there.

But I'm just as convinced that the problem isn't all as simple as some orthodox viewers might think. We live in a *political* economy. This fact tells me, for one thing, that exercising monetary discipline unmercifully would provoke a counterproductive reaction which would produce even worse inflation. So I believe the Fed should guard against precipitating a money crunch and a serious recession. I also believe that various governmental efforts on the social front are important to relieve undue and unfair impacts of recession or slow economic growth. I happen to have certain ideological reasons for thinking this way, but one can also believe this for purely practical reasons. Monetary discipline simply won't work unless there is awareness of these practical, political, realities.

So I'm wary of advice that the Fed simply turn the screw. Doing so without considering the pertinent circumstances could impose an unwise dose of monetary discipline.

UNORTHODOXY

Among those circumstances are the facts cited by those who take the unorthodox view. The economy *is* different than it was, and resorting to monetary orthodoxy in a world of economic unorthodoxy poses very difficult problems for the Fed. The various arguments I have attributed to those who espouse the unorthodox view fall into two categories. The first involves different forces external to monetary policy which the Fed has to decide whether to validate or not. The second involves the impact of inflationary expectations. Let me take each one in turn.

Validation. The most severe shock to the economy in recent years has come from OPEC increases in oil prices. Clearly, these increases have raised the *overall* level of prices as well as the price of oil. This needn't necessarily have happened, however. If other prices had gone down enough to offset the increase in oil prices, the OPEC action wouldn't have been inflationary. The Fed could have helped this come about by sufficiently slowing money growth.

As you know, we haven't done that and, in fact, have validated at least part of the increase in oil prices. The reason, of course, is that the OPEC shock in itself has tended to depress the economy, and for the Fed to add to that impact a highly restrictive policy would have had a very depressing effect. We have been in a Catch-22 position. If we had offset all of the OPEC price effects, we would have aggravated the recession. If we had validated all of it, we would have aggravated inflation. As a result we have followed a middle course.

The validation problem, however, was with us long before OPEC. It often comes with budget deficits, which many people regard as the most inflationary force of all. The record of large deficits is distressingly familiar, but let me mention a new fact that just has come to my attention: the 1970s promise to be the first decade in our entire economic history with not a single year of surplus.

Now, we in the Fed have been known to speak in loud and clear tones about the evils of budget deficits. The increased spending and borrowing which are involved tend, when the economy is operating relatively near capacity, to raise prices. But again, this needn't last if the Fed refuses to validate the higher prices by sufficiently slowing money growth. This hasn't happened. As in the case of the OPEC price increases, the Fed has validated part of the deficits and offset part of them.

Finally, the validation problem is associated with the wage-push phenomenon, which many who espouse the unorthodox view think is the main cause of inflation. When wages rise faster than productivity, they force prices up. If the higher prices are not validated by increases in money growth, however, demand will not support them. Producers will lay off workers, sales will slow, and the economy will turn down. In fact, the Fed has validated part of the price increases caused by the wage push.

I want to make two points out of all this. First, those who take the unorthodox view are *not* correct in asserting that OPEC, budget deficits, and wage pushes make monetary policy impotent. The Fed can offset all these forces by sufficiently slowing money growth. But, second, those who espouse the unorthodox view *are* correct when they say that these external forces greatly complicate the Fed's decisionmaking. OPEC actions, deficits, and wage-push pressures at the same time cloud the picture and sharpen the dilemma which the Fed faces.

In hindsight, it is probably true that the Fed has validated too much and not offset enough. Certainly, the rate of money growth has been higher than we would like it to have been. But responsible policy could not have had monetary policy offset all of these forces completely. The Fed does have a responsibility for weighing the risks of aggravating inflation against the risks of recession. You may not agree with how it has assessed these risks and acted on them, but it is hard to conclude that some validation of these external forces was an unwise thing to do. In the future, whenever the problem arises, each situation will have to be evaluated separately. Overall I would favor some validation, although not as much as in the past.

Expectations. Many of those who espouse the unorthodox view claim that monetary policy is ineffective because of inflationary expectations. The fact of increasing inflationary expectations is familiar to all of us. The magnitude of the increase comes as a shock. In the 1950s, inflation was expected to be about one-half percent (on *average*, that is, because in the early 1950s people were expecting deflation). In the 1970s, expectations have averaged close to six percent and currently are nearing nine percent. This increase in expectations is perhaps the biggest fact that distinguishes our economy from that in which orthodox policy was presumed to operate.

It raises questions, first, about the effectiveness of high interest rates. Mortgage lenders, for example, constantly marvel at how young couples can take on mortgage debts at 11 percent plus without seeming to bat an eye. The reason, of course, is that house prices are increasing at a rate closer to 15 percent; and if home buyers expect the trend to continue, the *expected* real rate is negative.

There is no question that inflationary expectations greatly change the way people regard high and rising interest rates. Yet, I believe the argument has been overdone. The fact that expected real rates are negative may mean that existing rate levels do not discourage some people from borrowing. But borrowers who incur debt at today's high nominal rates still take on large burdens of servicing the debt. Unless their incomes and cash flow are rising equally as fast as their debt burdens, they are going to feel the pinch. Many businessmen I talk with indicate that high nominal interest rates do indeed bite.

The most telling argument of the unorthodox viewers is that even a recession and high unemployment may not make a permanent dent in inflation. Rather than trading more unemployment for less inflation, we may find ourselves with more of both. Their reason, again, is inflationary expectations.

Back in the 1960s, economists seized on the so-called Phillips curve both as an explanation of what goes on in the economy and as a guide to policymakers. The Phillips curve showed that unemployment was low when wages were rising rapidly (during periods of inflation) and unemployment was high when wages were rising slowly (during periods of recession). Accordingly, policymakers who wanted to slow down inflation had to decide how much unemployment they were willing to tolerate.

Well, it is now fashionable to say that the Phillips curve is obsolete. Shifts in expectations shift the entire curve in ways that are hard to predict. Why? Because workers are concerned about their *real* wages and will demand higher wages to make up for higher prices. So we have two results. First, a higher level of inflation is now associated with any given level of unemployment. Thus, achieving price stability requires a bigger increase in unemployment in the short run than was the case 20 years ago. Second, rather than ending up with more of one and less of the other, we sometimes end up with more of both unemployment and inflation, or what has been termed stagflation. If inflationary expectations are rising fast enough, their impact on inflation can overwhelm the effect of a slowing economy or even a recession.

The point of all this is not that expectations make monetary policy ineffective but that they call for a different approach. The simple concept of monetary policy is that it tightens during booms and eases in recessions, and the record during the postwar period does show sharp changes in money growth and interest rates over the course of the cycles. But now, with inflationary expectations so high, this kind of up-and-down policy can be self-defeating. As the economy slows further in coming months, it will be important for the Fed not to move precipitously to ease. People need to see that the effort to eliminate inflation is proceeding by persistent steps to slow money growth. This persistence probably must continue for several years if inflation expectations are to be reduced.

SUMMING UP

So where does all this come out? By now you can see that the sharp distinction I made at the outset—between those who advocate a more orthodox view of the economy and those who say the world has changed so much that traditional monetary policy is ineffective—was overdrawn. There is some, but not complete, truth in both views.

Monetary discipline is essential to the elimination of inflation; the rate of money growth must be worked down. But the development of an unorthodox economy adds new constraints on orthodox monetary remedies. Undue tightness can produce counterreaction that will only embed inflation more deeply. Undue ease can aggravate inflationary expectations. Too much validation can make inflation worse; too little can lead to severe recession. The trade-off between inflation and unemployment is much more uncertain than it used to be.

I come out of this with the conviction that monetary policy is still effective but that it has become much more difficult and complicated. At the same time, good monetary policy is even more essential. I agree with those who argue that efforts are needed to strengthen the supply side of the economy. Vigorous steps to raise productivity will help to restore the dynamism of the economy and help to reduce inflation. But demand management is not obsolete; demand and supply management must reinforce each other.

Finally, in this environment the Fed has a special responsibility to lend an element of consistency to public policy. Fine tuning is now discredited (although I suspect that if the economy ever comes closer to what we once thought of as normal, it may come again into vogue). Our problems in these days of double-digit inflation are more gross. They require a firmer hand and a longer view. Whether the American people will sit still for a gradualist solution to inflation remains to be seen. Whether the Fed will be able to exercise the persistence and constancy which a gradualist solution requires remains to be tested. Certainly, if any institution can perform this role, the Fed, with its independence from short-run political influences, is in a position to do it.

From the Philadelphia Fed . . .

This new booklet contains summaries of four panel discussions of Philadelphia's economic future held at the Federal Reserve Bank in 1978 and 1979. Copies are available without charge from the Department of Public Services, Federal Reserve Bank of Philadelphia, 100 North Sixth Street, Philadelphia, Pennsylvania 19106.