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Remarks by

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Annual Human Relations Award Dinner

The Los Angeles Chapter

of the

American Jewish Committee

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I am delighted to be here tonight at this dinner honoring Harold Williams with the Human Relations Award of the Los Angeles Chapter of the American Jewish Committee. It is an honor he richly deserves. During his distinguished careers as a businessman and academic, Harold never neglected reaching out to the broader community in a variety of ways. His civic responsibilities took on greater intensity during the period of his solid leadership of the Securities and Exchange Commission. That is when I came to know Harold as a forward looking and thoughtful leader in dealing with the problems of financial markets and corporate governance. Since leaving the SEC, Harold's career has taken a challenging new turn, to the development of the J. Paul Getty Trust. Foundations -- private organizations with public purposes -- have long played a unique innovative role in American society; the Getty Trust, with its large resources and strong leadership is bound to make a strong impact in the arts and humanities. This occasion, I suspect, is as much a harbinger of accomplishments yet to come as a fitting tribute to the character of Harold Williams.

In some correspondence about this dinner, Harold suggested that I might somehow talk about how the realities of today's economic world blended with the concerns of humanitarianism. I must say, Harold, when I first got your letter I didn't know quite what to make of it. Were you not so subtly suggesting that monetary policy needed to be tempered by human considerations? Or, were you, perhaps subconsciously, providing an opportunity for me to improve my public image? Well, when I mentioned the

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challenge of talking about humanitarianism and central banking to one of my associates, he immediately responded by saying it would be a pretty short speech.

Upon further reflection, I decided it wouldn't be such a short speech after all. The harsh reality of today's world requires us to give some solid attention to why we are where we are and to where we are going, in terms of enhancing human welfare.

When we talk about human welfare we obviously have to consider a great deal beyond standards of living, employment opportunities, productivity, and other measures of material well being. But it is equally beyond question that a sense of economic satisfaction, stability, and order is important to us for itself, and without it other values are threatened. And so it is not irrelevant to consider the conduct of economic policy in general, and monetary policy in particular, with a group brought together with a common interest in the larger values of human society.

We are reminded daily of the dislocations, the pain, and the uncertainties in the economy today. Far too many are unemployed, housing has been depressed, investment is falling, and interest rates remain, by historical standards, high. And those concerns are not limited to the United States. Rich countries and poor, with few exceptions, are bedeviled by recession, unemployment and financial strains.

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What is less often noted is that these difficulties had been building for quite a long time. At least for a decade, roughly encompassing the 1970's, our economic performance had been deteriorating in fundamental ways. The origins for this country can be traced back as far as the mid-1960's, when, as a nation, we had for a while become infatuated with our apparent economic success. But no sooner did we congratulate ourselves on our presumed ability to conquer the business cycle, to achieve virtual price stability, and to maintain growth that we took it for granted.

That, I suppose, is one aspect of our common humanity -- and in doing so we refused to recognize what was necessary to sustain performance. One symptom was that we failed to accept the budgetary consequences of spending for a war and vastly expanded social programs at the same time. That may have seemed at the time "socially sensitive," but once we refused to accept financial discipline, the inflationary process got underway and many accepted it as a lesser evil. And once fairly started, it assumed a momentum of its own.

As we came to expect inflation, we built it into our economic arrangements, and anticipated it in our business decisions, in our financial planning, and in our shopping. We tended to leverage our capital, to reduce our liquidity, to divert our energies into more speculative and unproductive activities, to take risks in ways that could not be sustained. In the end, we found the growth we had taken for granted was

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undermined; by the end of the 1970's, growth in productivity practically disappeared.

It's worth recalling the culmination of the process in late 1979 and early 1980 when concern about inflation, the declining value of the dollar abroad, and the budgetary outlook combined to bring interest rates to levels never before sustained in this country and incited a speculative outbreak in commodity and precious metals prices.

As evidence of the corrupting influence of inflation mounted -- and not just on economic behaviour but on social goals and cohesion -- a new national policy consensus emerged. The need to reorient the economy toward greater price stability, increased investment, and improved productivity -- in short, toward the preconditions for sustainable economic growth, for higher real incomes, and for expanding employment opportunities -- was broadly accepted.

The Federal Reserve, by necessity, was thrust in the position of assuming the leading edge in the effort to restore price stability. In a fundamental sense, that was appropriate and inevitable because no inflation can be stopped without appropriate restraint on the growth of money and credit -- and in the last analysis that is our continuing job. But it is also true that job has been made more difficult because complementary approaches are weak or lacking. Instead of declining, budget deficits have risen. They now absorb a bigger share of our savings and place extra pressures on financial markets. For

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a long while businessmen, workers, and consumers continued to plan on, and act on, expectations of continuing inflation in their pricing, wage, and buying decisions -- and even now there is skepticism about whether the recent trend toward stability is "for real."

And, as the continuing demands for money and credit, public and private, clashed with restrained supplies, interest rates remained very high for month after month, with strong repercussions in the very sectors of the economy -- investment and housing -- important to our future well being.

In the circumstances, it is hardly surprising that some have begun to question whether it's all worthwhile -- that somehow there must be an easier "out," or that maybe inflation really was the lesser evil. Well, I have already implied that the adjustment could have been eased had budgets been under better control, had the world environment been more favorable, or had the public been less skeptical of the prospects of restoring price stability. But let's not engage in wishful thinking: In the best of circumstances, we should never have anticipated that dealing with ingrained inflation, and rebuilding a base for growth and productivity, would be fast and easy.

All that I would argue is that we had no real choice then -- or now. The longer the inflation persisted, the more difficult it would have been to control, with even more serious economic and financial repercussions.

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In this country we have, historically, been spared the economic and social disruption of really severe continuing inflation. But we had enough by the end of the 1970's to give us a taste of the implications. The true challenge for public policy, it seems to me, is to restore the conditions for growth in a way consistent with stability -- or in the end we will achieve neither.

I would also remind you our problems and challenges in that respect are not unique. Governments around the world have faced, in greater or lesser degree, inflationary, fiscal, and productivity problems. They are embarked on similar efforts to cope with them, and, as they have done so, growth has been slow or non-existent. One result has been that recessionary tendencies in various countries have fed back, one on another.

The difficulties in this situation are very real. But so are the opportunities. I am convinced that in the end the current strains and pain will soon give way to renewed growth and prosperity -- if we only have the wit, the wisdom, and the persistence necessary to capitalize on the opportunities before us.

The philosophy that has guided monetary policy in recent years has been grounded on those views. As you know, the Federal Reserve has argued consistently for a policy of restrained growth in money and credit. This policy means exactly that -- <u>restraint</u> enough to keep up the pressure against inflation; <u>growth</u> enough to support the needs of the economy.

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That policy of restrained growth in money and credit, I must emphasize, is not the equivalent of a high interest rate policy -- quite the contrary. I reject entirely the simplified view that the Federal Reserve over time can itself dictate the level of interest rates in the marketplace. Those interest rates reflect the balance of savings and investment, not just in the United States, but elsewhere in the world. They reflect the hopes and the fears of millions as they decide where to put their money, and how much to borrow.

In essence, lending for any period of time is an act of faith -- faith, among other things, that interest paid in the years ahead will yield a real return and not lag behind rising prices. Of course, monetary policy can influence those decisions and thus the level of interest rates. But it does as much or more by affecting the way we look at the future -- and most especially the prospects for stability -- as by the technical manipulation of bank reserves and the discount rate from day to day.

To put it bluntly, over time, achieving and maintaining the lower level of interest rates we would all like to see must be a reward for success in dealing with inflation; without a sense of conviction on that score, attempts to force interest rates lower would in the end be fruitless.

Happily, I believe we can now see evidence that the fundamentals are changing. We are still some distance from price stability. But we can now fairly claim the insidious

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upward momentum of inflation has been broken. I judge that partly by the fact that the common indices of inflation this year have been running at a third to a half of their earlier peak levels, and partly by the fact that growth in workers compensation in nominal terms has declined to the 6 to 7 percent area, while real wages are benefiting from the more rapid disinflation on the price side. I also believe we see signs that the hardened skepticism of financial markets and the public at large about our ability to deal with inflation -- a skepticism bred over years of disappointment and false starts -- is beginning to yield. One reflection is the rapid decline in long-term interest rates in recent months -- although they are still very high historically. And there are hard analytic reasons to believe that progress toward stability can be maintained during a period of business recovery.

Specifically, even if I discount by half what my business friends are telling me, business recovery should be accompanied by substantial gains in productivity. Combined with the trend toward more moderate wage and salary increases, the result can only be slower growth in unit labor costs, which, I would remind you, are two-thirds of all costs in our economy. For the time being, excess capacity and unemployment are, of course, putting downward pressures on prices. But they cannot be the answer long-term -- we have to "build-in" the discipline and the expectations that will keep inflation declining as recovery takes hold.

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I do not equate our progress against inflation so far with victory -- far from it. Concern about inflation is not something we can afford to turn on or off -- not if we want to see that progress continue and price stability restored. And that concern has straightforward implications for the broad directions of monetary policy in the period ahead, although regrettably it does not resolve the myriad of detailed matters that arise in the formulation and conduct of a specific policy course.

For instance, while we know that the inflationary process feeds on excessive growth of money and credit, we are faced today with particularly difficult problems in judging what is "excessive." We know institutional changes are currently distorting some of the various M's that we have used as guides for our actions, and we also know that the current period of economic uncertainty has been accompanied by exceptional demands for liquidity. To hold rigidly to pre-determined targets that could not take these factors into account would risk a significantly greater degree of restraint than intended. For all the problems of communication to a worldwide audience that has become habituated to particular statistical relationships, we cannot afford, during this sensitive period, to substitute form for substance in our policy-making.

But we also must be wary -- we are wary -- of permitting liquidity to build up to the point that, with the passage of time, inflationary forces could again get the upper hand. The

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right balance is, in the end, a matter of judgment -- but it is a judgment that has been, and will continue to be, tempered by the lessons of our past inflationary record.

What is not a matter of judgment but a hard fact is that the inflationary dangers and the interest rate outlook is greatly complicated by our national fiscal position. In the fiscal year just ended, the Federal deficit was $111 billion, and it will probably be much more than 50 percent higher in the current fiscal year.

In assessing the impact of that huge current deficit -- around 5 percent of the GNP -- it is important to distinguish between the "cyclical" and the "structural" components. The "cyclical" component, as the term implies, relates to the effect of current business conditions on the Federal budget. High unemployment cuts,revenues and increases spending, temporarily enlarging the deficit. As the economy recovers, that cyclical element will diminish.

It is tempting to suggest that the "budget problem" can be dealt with as a passive by-product of recovery -- and I am afraid some in Washington are in a mood where they may not be above temptation, but it is wishful thinking. The hard fact is that, as things now stand, the deficit will remain close to current levels even as the recession passes. As the "cyclical" portion of the deficit recedes, we will face a <u>growing</u> "structural" deficit -- that is the imbalance that would remain even when the economy is operating at a high level, with reduced inflation. I know of no competent budget analyst who comes to any different conclusion.

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Left unattended, that situation poses a strong potential for a clash between the need to finance the deficit and the rising financial requirements for housing and for the business investment needed to support lasting growth in productivity. In the end, all those needs have to be supplied by savings -- and there simply isn't enough to go around.

The problem can in no sense be solved by monetary policy. The Federal Reserve can create money and liquidity, but not savings. Simply pumping out more money and liquidity, year after year, to meet the needs of the government would only risk renewed inflation. Sooner or later -- and it's all too likely to be sooner -- investors would be driven away from the long-term markets once again, and savings would be diverted into inflation hedges. The alternative of the government bidding away a limited supply of credit from the homebuyer or businessman is hardly more inviting -- and would also be reflected in high real interest rates. Understandably, concern about one or the other of those "scenarios" feeds back into today's markets, tending to keep interest rates higher than they would otherwise be.

There was meaningful progress on this front in the passage of tax and spending legislation last summer. Living and working in Washington, and at one remove conscious of the pressures converging on your elected representatives, I am well aware that further progress will not come easily. All I will argue is that it is <u>essential</u> to sustained recovery.

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To repeat the point, I am not so concerned about the "cyclical" component of the deficit -- which will account for half or more of this year's imbalance. Indeed, analytically, that portion might be viewed as almost benign, helping to support economic activity and smoothing the adjustment to a more stable economic path. When private demands for credit are relatively weak, and the economy is in recession, large deficits can be financed. But the underlying structural deficit is growing; left unattended, it will retard our economic progress in 1984, in 1985, and in the years beyond. No resolution in the Congress about interest rates, no different targets for monetary growth, no change in the structure of the Federal Reserve can substitute for savings or reduce the structural budget deficits. If we are concerned about money for investment, the problem has to be hit head on.

A few moments ago, I alluded to the broad parallels that exist between our own economic situation and that in many other countries, and to risks these problems may aggravate each other. The problems of the rest of the industrialized world and their policy approaches are so similar to ours that I need not linger over the analysis. What does warrant more elaboration tonight -- partly because it is without precedent on such a scale in postwar experience -- is the need for practical programs of economic and financial adjustment in much of the developing world, where the contrast between human needs and economic reality is so stark.

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The developing countries, for all their problems, have been a growing, dynamic feature of the world economy. Even during the 1970's, in the face of enormously increased energy prices and slower growth in the industrialized world, they maintained strong forward momentum. The middle classes developed. Despite enormous population growth, some inroads began to be made on poverty. The economic base for more stable and more democratic political processes was developing.

That progress was marred, however, by increasingly large external payments problems. The current account deficits of all non-OPEC developing countries soared to $75 billion or so after the second oil crisis and continued at that rate into this year.

For a time, those deficits were supported by a vast expansion in international credit. Some of that credit was official -- relatively inexpensive and long-term. But an increasingly large chunk was from commercial banks around the world.

The process of rapid debt accumulation by the developing countries could not be sustained indefinitely. For the borrowers, debt in relation to the capacity to service that debt rose. Lending banks found ratios of loans to capital or assets rising significantly.

The problem was brought to a head by a combination of circumstances. Sharply higher interest rates increased debt service requirements rapidly. The widespread recession in the

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industrialized countries and the declining level of real world trade restricted markets for the exports of the developing countries. Declining commodity prices put further pressure on many developing countries still dependent on commodity exports for a large portion of their foreign exchange earnings. Political problems, particularly in Eastern Europe, raised further doubts in the minds of lenders.

The result is that in recent months we have had to come to grips with an urgent need for what economists euphemistically call adjustment. At the same time, we need to assure residual financing needs of a number of developing countries can be met. And both the adjustment and the financing should be developed in a way that can help lay a base for sustaining future growth.

Success in the first instance will fundamentally rest on something only the borrowing countries can provide -- a demonstration that they can, in fact, take measures to increase the productivity of their own economies and to close the gap in their external payments. In the short run, the necessary measures may unavoidably stop internal growth for a while. But the more orderly and effective the adjustment -- the more quickly confidence can be restored -- the more rapidly growth can be resumed and sustained. At that point, our own export markets and those of other industrialized countries will benefit and any lingering questions about the possible impact on international banks will be put to rest.

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It is precisely for these reasons that there exists the strongest kind of community of interest among borrowers and lenders, among governments and private businesses, and among the developing and industrialized countries, in working together to find effective answers to the evident problems. Each of the parties has a critical role to play -- sometimes together, and sometimes separately. What is especially important is that all these participants achieve a high degree of common understanding, recognizing the potentialities and limitations of each for action. On the basis of that understanding, we can then deal forcefully and effectively with the problems at hand.

I do not underestimate the difficulties of the internal adjustments for relatively poor countries, often with rapidly growing populations and beset by political problems. But we are also fortunate that the principal countries involved have important economic strengths, demonstrated growth potential, and able economic officials who understand the needs and requirements of the situation. Current liquidity problems need not be -- and for the major borrowers they are not -- symptomatic of inherent economic weakness.

Here in Los Angeles these abstractions take on perhaps a little more concreteness in the case of Mexico. As you know, Mexico and the IMF have hammered out a working agreement on needed policy adjustments and a comprehensive program is being assembled to assure necessary external financing. Taken

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together, these steps have the capacity to stabilize the situation and to begin to restore the fundamental health of an economy that sustains 72 million of our neighbors. The Southwest shares a 2,000 mile border with Mexico, and Mexico is the third largest export market for the United States, accounting for $18 billion in sales in 1981. Add to this our human, cultural and financial ties, and the orderly functioning of the Mexican economy has obvious significance to us all.

While the case of Mexico may seem more concrete to us because of our proximity, other countries must cope with similar problems, with similar human dimensions. For instance, Argentina, Brazil, and Yugoslavia in varying degree all face adjustment needs and we and the international community at large have a substantial interest in that process proceeding in as orderly and expeditious way as possible; each of those countries are in negotiation with the IMF, and each has called upon, or requested, interim financing from the United States and others, public or private.

The fact is that borrowing countries, even with the strongest kind of steps to get their own houses in order, will require some residual ongoing financial support to permit their economies to continue functioning smoothly. Agreement with the IMF brings with it the availability of certain amounts of medium-term financing, usually over a three-year period. But that may not be adequate, particularly in the early stages of the transition. The importance of the Fund lies as much or

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more in the fact that -- as a dispassionate and impartial international institution -- its imprimatur on a borrowing country's program will reinforce the confidence of other lenders, paving the way for additional extensions of official and private credit that may be needed to assure that the adjustment program can be carried through to fruition.

Again to take a case in point, the new leadership in Mexico has undertaken a rigorous program to implement the plans agreed with the IMF in the last weeks of the previous government. Some of those measures may appear harsh in terms of budgetary discipline, reduced subsidies, and restraint on growth. But they also offer promise of a stronger economy, with sustainable growth, over a longer period. Without the framework of internal discipline and external financing, surely the adjustments for Mexico would be even more severe, and without the same prospects for recovery and future growth. The reasons are evident: within the framework of the new program, creditors can resume lending with more confidence, exporters can resume shipments of essential goods, distortions and dislocations in the internal economy can be reduced.

In emphasizing the need for internal adjustment by borrowing countries as an essential first step, I also recognize that the ultimate success of their efforts will also be dependent on an expanding world economy. One threat is that the worldwide recession has brought new pressures for protectionism, here and elsewhere. I understand these pressures -- we all do. The case is pressed in immediate terms -- to save

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jobs and to save companies. But the trouble is that protectionism is a game everyone can play -- and in the end it will not save jobs; it will lose them as growth and export markets are disrupted. I might point out there is no logic in suggesting to developing countries that they make their economies more productive and competitive in export markets -- and counting on those exports to support and strengthen their financial position -- only to refuse them markets for those same exports.

Economic recovery, of course, would relieve these and other pressures in the most constructive way. It would permit developing and industrialized countries alike to pursue the necessary adjustments in a favorable environment. Indeed, adjustment efforts -- involving a temporary period of slow or no growth -- appropriate to an individual country won't work as planned if many countries are simultaneously in the same position. We cannot all reduce imports and increase exports together -- not unless we are trading with the moon.

Obviously, we would all like the U. S. to lead the way to expansion. I share the general view that recovery in the United States will be evident through 1983, although at a moderate rate of speed -- probably slower than during previous post-recession years. I know that unambiguous evidence that the recovery is already underway is still absent. But encouraging signs are evident in some rise in housing, in the improved liquidity and wealth and reduced debt positions of consumers, and in surveys

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reporting that attitudes and orders may be stabilizing or improving, even if from unsatisfactory levels. The Federal deficit, while fraught with danger for the future, is of course providing massive support for incomes at present. The rather dramatic declines in interest rates in the latter half of this year, albeit to levels that are still high by historical standards, are relieving some of the financial stress and providing support for some expanded activity.

The temptation is to pull out all the stops in an effort to hasten the recovery process. But -- contrary to the impressions of some -- neither the Federal Reserve nor any other policy body can <u>by itself</u> achieve that result. And beware of the effort to try "at all costs," oblivious to the danger of reigniting inflation, or of undermining the progress toward cost control and productivity. To do so would simply perpetuate and aggravate the pattern of the past. What is crucially important -- particularly in the light of the experince of recent years -- is that we set the stage for an expansion that can be sustained over a long period, bringing with it strong gains in productivity and investment and lasting improvement in employment.

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I have emphasized the importance of maintaining progress toward price stability to that outlook. I am convinced that with disciplined monetary and fiscal policies, we can sustain that progress. But I also know there are obstacles, present and potential -- a perpetuation of huge deficits, a closing of our markets to competition, a refusal to support the efforts of other countries to adjust -- that would all work against recovery.

If we turn back those temptations, as I believe we will, then we will indeed have set the stage for turning the 1980's into the mirror image of the 1970's -- a decade in which doubts and uncertainties give way to renewed confidence and vigor. I would like to think, Harold, that the improvement in economic welfare I have been talking about tonight will be part of the continuing struggle to advance the human welfare -- the struggle that you have joined in so many dimensions in your own career.

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