A TIME OF TESTING

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It is a very special privilege for me to have the chance to address so many bankers in assembled convention—but, just in case there are any doubts, I did not arrange the Federal Reserve announcements last weekend to honor this occasion.

In fact, those measures were not designed to make your life as bankers easier. Their purpose is rather to deal forcefully and responsibly with the economic and financial situation as we see it: strong inflationary pressures; concern, exaggerated concern in my judgment, that excessive growth in money and credit might be permitted by the Federal Reserve, fueling still more inflation; and an emerging speculative atmosphere and unsettled markets that could only complicate the job of restoring and maintaining orderly economic growth at home and stability in the dollar abroad.

I need not review with you all the trends and developments of recent years that have brought us to this crucial period for economic policy, nor emphasize the relevance of policies beyond the monetary and banking area. The problems and dangers are plain to see. Indeed, in our perhaps understandable preoccupation with what is wrong at the present time and in our doubts about the future, there may be another danger that is not so obvious; a justifiable sense of concern can spill over into a debilitating and unjustifiable sense of impotence and weakness.

The Facts Do Not Justify Cynicism. The simple fact is that, after months of focusing on our economic problems:

- More people are employed than ever before, over 10 million more than five years ago.
- An exceptionally long period of expansion has helped encourage and sustain investment despite inhibitions in the tax, regulatory, and inflationary environment.
- The Federal budget has come under better control, with spending moving somewhat lower in relation to the size of the economy, and with a substantially reduced deficit over the most recent years.

- In the face of unprecedented inflation and enormous new increases in energy prices, wage trends overall have not appreciably accelerated this year, reflecting, despite some disturbing exceptions, the discipline and good sense of Americans in general in accepting the need for restraint.
- Amid the strains imposed by the high price of oil and sometimes turbulent foreign exchange markets, a high degree of international cooperation has been maintained and protectionism has been checked—enabling, among other things, a substantial growth in American exports.

We would, of course, be blind if we failed to recognize that all these achievements, and much more, will be jeopardized by any failure to come to grips with the inflation that has become so pervasive. Monetary policy inevitably has an essential role in the process of restoring stability. The new Federal Reserve actions are a part of that continuing process.

Those measures were specifically designed to provide added assurance that the money supply and bank credit expansion would be kept under firm control. There will be one seemingly technical, but potentially significant, change in procedure in conducting open market operations. More emphasis will be placed on limiting the provision of reserves to the banking system—which ultimately limits the *supply* of deposits and money—to keep monetary growth within our established targets for this year. We have raised the discount rate—and will manage it more flexibly—so that restraint on bank reserves will not be offset by excessive borrowing from the Federal Reserve Banks. We have placed a special marginal reserve requirement of 8 percent on increases in "managed liabilities" of larger banks (including U.S. agencies and branches of foreign banks) because that source of funds has financed much of the recent buildup in credit expansion. That requirement, admittedly cumbersome by its nature, will be maintained so long as credit expansion is excessive.

None of these actions will prevent moderate growth in money and credit commensurate with the needs of the economy; they are designed to curb excesses that would otherwise spill over into inflation. Let me speak quite directly and frankly to the responsibilities of the banking system and banking leaders in that connection. One of the glories and strengths of our system is that we rely on private markets and decentralized decisions, responding to market incentives, in pricing and allocating credit. But

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those decisions do have to be made by all of you individually in your own institutions. In a situation in which there could be greater day-to-day or week-to-week volatility in money market rates—not in itself a matter of great consequence for the economy—pricing of your own loans seems to me more a matter of responsible business judgment than of following a rote formula, related solely to the cost of some small margin of

loanable funds. The Board of Governors has particularly stressed its own concern that, in a time of limited resources, banks should take care to avoid financing essentially speculative activity in commodity, gold, and foreign exchange markets. Bankers familiar with their own markets can, without doubt, make judgments that none of us in Washington can, or ever could, make about what loans best serve the continuing needs of customers, business and personal, and the country alike. But my general feeling is that this is hardly the time to search out for exotic new lending areas or to finance speculative or purely financial activities that have little to do with the performance of the American economy, and indeed may detract from it.

This is a time of testing—a testing not only of our capacity collectively to reach coherent and intelligent policies, but to stick with them. In approaching this test, the facts do not justify the skepticism, and even cynicism, that is heard on so many sides.

- Some would suggest that we, as a nation, lack the discipline to cope with inflation.

  I simply do not accept that view.
- Second, some would argue that inflation is so bound up with energy prices, sluggish productivity, regulation, and other deep-seated forces that monetary and fiscal policies are impotent.

  I do not accept that view.
- Third, some would stipulate that we face impossible choices between prosperity and inflation.

  The simple facts of the past, in the United States and elsewhere, refute that view.

Let me take the first point. I do not claim any special expertise in reading public opinion. But the dramatic swelling of national concern about inflation—a concern that seems to transcend economic, social, and indeed political philosophies—seems to me unmistakable.

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We need not rely on opinion polls or personal impressions. We have been assailed almost daily for months with learned and not so learned analyses about the prospects for a downturn in business activity. I understand the reasons for concern, particularly given the high level of inventory accumulation in recent months. But the Administration and the Congress have united in clearly rejecting the seductive course of budgetary easing and tax reduction in recognition of the ultimately greater threat to stability inherent in the inflationary process. Restrictive monetary policies are never calculated

to win popularity contests; yet there has been acceptance of the need for restraint even at rates of interest that are almost outside the range of our historical experience.

Indeed, the Congressional committees responsible for oversight of the Federal Reserve have been among the strongest voices urging that we set forth and adhere to monetary targets, reducing them over the years ahead as an essential part of the effort to restore price stability. I believe we are coming to understand that our only real prospect of early and sustained declines in interest rates lies in coming to grips with inflation. I would note too that the "National Accord" recently reached between the Administration and American labor leadership plainly recognized the threat to full employment, incomes, investment, and growth inherent in the inflationary process, and for those reasons gave "top priority" to the "war on inflation."

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Long Term Discipline is Required. Of course, the skeptical can suggest that the consensus will buckle and fracture under the first real strains. But in assessing the prospects and policies, let us be clear on one important analytic point. There is clearly a time when, if business activity should recede, some of the outward manifestations of fiscal or monetary policy—the size of the budget deficit or interest rates—will change. Built-in stabilizers in the budget come into play, increasing the deficit temporarily. When the money supply is brought clearly under control and expectations of inflation dissipate, interest rates will tend to decline, and our recent actions should bring that day sooner, whatever the initial impact on interest rates. Developments of this sort are in no sense inconsistent with maintaining the firm discipline on Federal spending and growth in the money supply that will be required over a long period of time to restore price stability.

Some have raised the question of tax reduction. If earned by sustained spending restraint, well-structured tax reductions—by which I mean changes that would help stimulate investment, cut costs, and offset the effects of inflation in moving people into higher tax brackets—could be welcome at some time in the future. That time has not yet come, nor is it useful now to speculate when it might. What we need to guard against is premature and excessive stimulus, during expansions as well as recessions—and it does seem to me that we have come a long ways, at the very least, toward learning that lesson.

I do not minimize the influence of more structural factors in our inflation—least of all the deplorable performance of productivity and the impact of energy prices, now rising at a rate of 70 to 80 percent a year. The traditional instruments of monetary and fiscal policy can do little directly to influence productivity or the supply of oil.

But let us not lose sight of the fact that inflation not only grows in part out of these factors, but that oil pricing and productivity performance are themselves influenced by the instabilities and uncertainties related to the underlying inflationary process. Attempts to pin all the blame for inflation on factors outside of our control would only doom our efforts to futility.

We can take some comfort from the fact that the rate of inflation in most sectors of the economy is today substantially below the levels so depressingly reported month after month in the headlines; energy alone has added about 3 percent to the consumer price index in the past three months. As the rate of increase in energy prices subsides—as it should in coming months—the inflation rate as a whole should also decline appreciably. Looked at another way, the immediate challenge is to avoid imbedding the current rate of inflation in expectations and wage and pricing decisions before the current bulge in prices subsides. That is not an unrealistic objective, but it is one that will require discipline over the months ahead.

Either/Or Theories No Longer Enough. That necessary discipline seems to me challenged by what I think of as the theories of "either/or":

- Either we fight inflation or we prevent a recession.
- Either we seek a strong and stable dollar internationally or we attend to our problems at home.
- Either we do what's good for the long run or we follow short run expediency.

There was a day when our problems seemed to fall into such convenient analytic compartments. Most economists of my generation have made a career of analyzing so-called "tradeoffs" between inflation and employment, between external and domestic stability, between the long and short run. But that theorizing has been rooted in certain assumptions—assumptions that are now suspect—about the stability of expectations. When expectations of future inflation are so strong and potentially volatile as they have become, the "tradeoffs" disappear, or they appear in a much different light.

The lesson of the 1970's—here and abroad—simply does not bear out the "either/or" approach.

- More inflation has been accompanied not by less, but by more, unemployment and lower growth. We have not "traded off" one for the other.
- A weak dollar externally aggravates inflation at home, and a weak dollar at home undermines the dollar abroad. Fundamentally, what disturbs Peoria disturbs Zurich.
- After years of inflation, the long run has caught up with us. We can no longer blithely assume we can "buy" prosperity with a little more inflation, because the inflation itself is the greater threat to economic stability.

The real message of these lessons seems to me more hopeful than discouraging. Let me state the propositions in a more positive way.

"When expectations of future inflation are so strong and potentially volatile as they have become, the 'tradeoffs' disappear, or they appear in a much different light."

Turning the Corner. As we turn the corner on prices, upward pressures on wages and other costs—including interest rates—should subside. As confidence in the currency is strengthened, improving conditions in money and capital markets will help support

investment activity, and we should have a firmer base for investment planning, improving the outlook for purchasing power and productivity. A stronger dollar at home will bring it renewed strength internationally, and a strong dollar abroad will support our efforts to combat inflation at home. Appeals for moderation in petroleum pricing would have a new force and substance.

I do not delude myself that this is yet the world in which we live.

"As confidence in the currency is strengthened, improving conditions in money and capital markets will help support investment activity, and we should have a firmer base for investment planning, improving the outlook for purchasing power and productivity."

What we can do, and I see no reasonable alternative, is to start the process—to turn the corner—to demonstrate the conviction that we have the wisdom and fortitude to maintain the financial discipline required to cope with inflation. In the process, we must, of course, be mindful of the business situation in the United States—and I count on you to make the lending decisions that distinguish between the support your customers require and the excesses that only aggravate and distract the adjustment process that is under way.

When I accepted this invitation to speak to you, I had a quite different address in mind—one focusing on the so-called "membership" problem and the necessary restructuring of reserve requirements. I decided to forego that theme in light of recent events. But let me note the obvious—that the problems are not unrelated, for they both concern the role and effectiveness of monetary policy and a strong central bank.

The central purpose of the proposed legislation is, after all, to strengthen our ability to conduct monetary policy in all foreseeable circumstances in the years ahead, and to do so in a context of fair and evenhanded treatment of competing depository institutions. That seems to me a practicable, achievable objective in this Congressional session. I am greatly encouraged by the convergence of views among affected institutions—what has seemed so controversial for years now approaches consensus. That in no small part reflects the responsible efforts of the leadership of this Association and individual bankers throughout the country.

In the weeks ahead, I welcome your efforts and your support—together with that of other affected institutions—in seeing this vital piece of legislation move through the Congress in acceptable form.

No industry in America plays a more pivotal role in our overall economic performance than our banks. Current developments underscore the point—but it will be true in the decades ahead as it is today. The implied responsibilities are heavy. But seldom are we offered the opportunity to meet a major immediate challenge to our prosperity and stability, while at virtually the same time strengthening the base we need for effective policy in the decades ahead.We can afford to do no less than rise to those challenges. ■