Remarks

by

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I think it might be helpful if I made some observations about my own experience in what we are trying to accomplish at the Federal Reserve. I will try to avoid stepping on the toes of George Schultz--who will straighten us out later from his own experiences--and Bob Carswell, who will no doubt make sure the Administration's position is clarified. You know the Federal Reserve is supposed to be independent, which means it can criticize the Administration but, of course, the Administration can't criticize it. And that's a wonderful independence that we must maintain. So Bob, stand by. At the risk of poaching, I'll offer you some criticism and hope that you won't reciprocate.

I'd like to say that in my short experience of seven months at the Federal Reserve, I've tended to think of my role, my own assignment, as involving three main areas. One is the whole area of monetary and economic policy. This is quite distinct and quite separate from the second area, which is the financial system--the regulation of banks and the payments mechanism. The third function is Federal Reserve operations: the 12 Federal Reserve banks, 25,000 people, a system that needs to be run efficiently, and effectively, that needs to seek excellence and quality and indeed to be a star in demonstrating that government agencies can perform with the same quality of efficiency and in improvements in performance that are characteristics of the private sector. That requires a lot of attention.

I thought this morning I would stick to the monetary and economic policy side, because I think this is the area that is most on your minds. While there are those here who would be interested in the banking system and the major changes that are necessary in it and are indicated in order to prepare for the coming decades, nonetheless, I think that the most important issues we are facing are the monetary and economic policy issues.

As you know, inflation is our most serious problem. It is a clear and present danger to our nation, to our system, to our way of life. There is no doubt that monetary policy has a key role to play in trying to wring that inflation out of our system and bring us back to the price stability that will give us our chance for economic progress.

I'd like to mention just a few things about monetary policy and what we are trying to accomplish. There is a good deal of speculation from time to time on how monetary policy is exercised and while it's rather interesting to read this speculation, what really happens is usually a little different. What the Federal Reserve is really trying to do through its monetary policy is to control the rate of growth of the money supply. I don't want you to be confused, and I would like to clarify completely how this is done. It isn't done by pegging interest rates, and it isn't done by setting the money supply on an automatic dial; it's neither of those. The technique that has been developed over a decade of trial and error is to control the money supply through open market operations by buying and selling securities. Buying securities puts money into the system; selling securities pulls money out of the system.

The controlling body for this determination of the money supply is the Federal Open Market Committee, made up of the seven Governors of the Federal Reserve System and five of the twelve Reserve Bank presidents, four of whom rotate turns. The New York Bank President is a permanent member. This body must give direction to the people who do the actual buying and selling. And the way they do that is to look at economic data and money data and their own expectations about the economy and to try to gauge what rate of growth of the money supply would result in the interim period between their meetings by telling the Desk to do A, B, C, or D. The shorthand way of telling them what to do is to say that we think money supply will be so and so if you operate within this range of maintaining interest rates tighter or slacker or whatever. The problem is that sometimes it gets translated by the Press into terminology like, "The Federal Reserve is trying to peg interest rates, and we don't pay any attention to money supply." I just want to assure you that that's not really the way it works. When you are running your businesses and have to give instructions to your production line you normally tell them how many units to deal with or give them some measure to deal with. Similarly, we try to tell the Desk to deal in something that can be measured daily in order for us to get a certain result. So I hope that misunderstanding can be cleared up.

I'd also just like to comment that it would be wonderful for me and for you and for everybody if there was a simple way to exercise monetary policy. If we could set the money growth on a dial and put it on automatic pilot and go home, my life would be so simple. But, unfortunately, that isn't the way the real world operates. We have a very complex system in which the actions of all of you and all of the people who deal in money affect what we define as the money supply. It can be affected by exogenous forces, either short-term or long-term. And if we should try to react, using some kind of automatic dial, to conditions that are very superficial, we could do tremendous damage, because we could overlook the underlying fundamental direction that we are trying to achieve for the economy.

For example, in April, tax payment day happened to come on a weekend, so everyone had until Monday to pay taxes. In some States, Monday was a holiday, so it was Tuesday before some people had to pay. Everybody marshalled their cash in their accounts by Friday to pay their taxes, and sent their checks over the weekend. It was five billion dollars more in money not withheld through payroll taxes than the year before--not just five billion dollars, but five billion more than the year before--an enormous flood of money into the Internal Revenue Service and into the Treasury. And because it was so massive it took them several weeks to process those checks and get them deposited is so long-period of time money that had been transferred to the Government wasn't taken out of the money supply. It produced a phenomenon that looked like money was going through the roof. If we had moved the economy to counter that phenomenon we would have cracked the economy and driven interest rates up to 15 per cent, reacting to something that wasn't real. And so we have to recognize these kinds of factors so that we don't become mechanistic and do great harm to our economy because we have not been willing to look below the surface to see what's really going on.

Monetary Policy has inadequacies, it has limits, it operates with lags. We all know this. And yet, because we are Americans used to instant results, we have impatience. And because monetary policy, which has been tightened tremendously in the last six months, hasn't produced results, we say it's ineffective. At the same time, we know it takes six to nine months before we get effects. Therefore, we often defeat ourselves by asking for action which later proves to be a case of "why did we do that to ourselves?" We do have that lag effect, and we have to wait in correcting excessive growth and we have to wait sometimes to be sure that we don't undermine the rate of growth of money so that we maintain a sound economy. We have to remember that I think.

There is also another element of monetary policy, and that's how it relates to fiscal policy. It no doubt would be simple if everyone could say, "Well, there's just one thing to deal with, and that's Monetary Policy;" that would solve all of our problems. I suppose, technically, that could be true. But let me explain to you that if the Federal deficit should be increased by $25 billion, whatever monetary policy were in effect it would have to drag 25 billion dollars more out of the economy just to stay even. And while that could be done, the consequences for the economy would be far different than if the Federal deficit hadn't been allowed to go up $25 billion. The condition when more resources are left in the private sector is both healthier and makes monetary policy easier to administer. Yes, we could take out what Congress puts in, but if we did that the consequences and side effects would be rather serious.

Let me go back for a moment to March 8, when I was sworn in, and give you some of the conditions that then existed. Then I'll tell you what we've been trying to do with Monetary Policy, and I'll give you, briefly, some of the longer range issues that I think are important.

On March 8, when I was sworn in, the economic plan of the nation contemplated that real growth of the economy would be about 4-3/4 per cent in calendar year 1978 and would continue about 4 per cent or 4-1/2 per cent in 1979. It was planned that the FY 79 budget presented to Congress in January would involve expenditures of 500 billion dollars and a Federal deficit of $60.5 billion. It was apparent that the reason for this was concern about the unemployment rate which had persisted since the great recession of '74-'75. But the fact was that inflation was breaking out of its 6 per cent mode. This was not yet perceived, and therefore the economic plan was unrelated to the real danger to the economy. The dollar was in trouble at that time; I spoke about that with the Council at length in May and unless there are questions I might not take your time on that. But those were the conditions.

What is the objective of monetary policy in the face of the break-out of inflation, and in the face of an accelerating Federal deficit at high rates of real growth in a very mature business cycle? Our reaction was to move progressively to slow the growth of money, and, in doing so, to slow the growth of the economy.

Another objective was to change the rate of growth of the economy smoothly, to avoid disruption, dislocation, to avoid jerking around the passengers and confusing them. We had to do this by maintaining balance in the economy, so that we created no distortions in any sector, and this in turn required some unusual efforts to maintain housing and to avoid a percipitous decline in housing as happened in '74. In 1974 the disintermediation of money flowing to housing resulted in housing starts decreasing from an annual rate of 2-1/2 million to 900,000 in a matter of months, which was disastrous. It wasn't a recession; it wasn't a depression, and it resulted in many bankruptcies. So we wanted to avoid that by keeping the economy in balance while bringing down the rate of money growth. We wanted to avoid recession because in my view, at least, recession is not the way to cure inflation in our current economic and political system. A recession would greatly increase the Federal deficit, bringing back the stimulus we just tried to take out, and it would undoubtedly bring cries for reflation to overcome the distress from all sectors, particularly from businesses. The medicine of recession is usually not sustainable. The medicine of low growth rate for a substantial number of years is the equivalent of a recession during a rebound, but it is much easier on the nerves and much easier on the welfare of Americans, generally and individually.

At the same time that we were trying to do these things--which are minor miracles in themselves--we were trying to involve other Government economic policy-makers in the fight against inflation. Recognizing that monetary policy cannot do the job alone in our system--or, that if it does, the consequences are very distressing--for fiscal policy needs particularly to be harnessed in with monetary policy so that the left hand doesn't give what the right hand is trying to take away and that we find a balance that gives us the best policy. What is in progress today in our efforts is, in the first place, that the real rate of growth of the economy for this calendar year has been reduced by one per cent from the projected 4-3/4 per cent to probably 3-3/4 per cent. For 1979, we are now looking at growth rates--you had your estimates and they may be different from mine--my guess is a growth rate in the 3-3-1/2 per cent range--maybe nearer to three; this is a substantial dampening but a sustainable rate of growth. On the fiscal side, the projected deficit for FY 79 of $60.5 billion has now been reduced to $38.6 billion--$22 billion of stimulus has been taken out of the economy on the fiscal side, thereby greatly easing the monetary role. I might say that just for the fourth quarter alone this change in policy means that the Treasury will be borrowing something like $7-9 billion less than it would have. You know what it means in the money markets to have the Treasury borrow that much less and thereby put that much less crunch on the system. But let me warn you that whatever we have accomplished in monetary policy in the last seven months is only the opening skirmish in the long fight against inflation. The forces of inflation were built up over 12 years, and it's going to take many years to wring inflation out. Success depends not on treating the symptoms but on curing the fundamental causes of inflation. Success will require the exercise of fiscal and monetary discipline over five to seven years, something we have never done in this country. It will test our individual and collective wills, our determination, our skills. It will test our economic and political systems and we are going to be tested in this period to see if we have the constancy of purpose to really mean it when we say we think inflation is a deadly disease and that our future well-being depends upon its eradication.

I had the pleasure to speak to the Bay Area Council in June, and at that time I outlined some of the longer range aspects of anti-inflation policies that I thought were essential. I'm pleased to say that some of them are now getting a good deal of attention and many ideas are being developed to deal with some of the issues I raised in San Francisco. They weren't original points, but they were certainly a list of things that are essential over time if we are to conquer inflation. Many of you have suggested these and others.

Let me tick off some of them: One is that we must move progressively to a balanced budget. I said in June that I was convinced we could have a balanced budget by 1982 without disrupting the economy, by gradually turning down the deficit and therefore creating a smooth flow into a new economic mode. I now think it's possible to do that by 1981 because at the time I spoke we were still struggling with getting that FY '79 deficit below $50 billion; now it's below $40 billion. If its going to be $38 billion or less in the current fiscal year there is certainly no reason not to get down to the twenties by fiscal year 1980 and certainly it should be near balance by 1981 and no later than 1982.

The second critical factor is to reduce the relative role of the Federal Government in our economy as progressively as we can without disrupting the economy. Here, you've seen a great deal of attention being paid to the idea of reducing the Federal Government's role from 22 plus per cent of our GNP down to 20 per cent or less. Again, the only way to do this effectively is to do it progressively, year by year making the rate of growth of Federal expenditures slower than the rate of the growth of the economy. If, over 5 to 7 years, we reduce the Federal Government's role to below 20 per cent of our GNP, we will have made a permanent change in policy that will be very important in our fight against inflation. This means that in 5 years we can transfer $75 billion to the private sector, where the individual decisions of people and businesses will be far more effective in maintaining the economy.

A third important and essential element is to regain our progress in productivity, and this requires a substantial increase in business fixed investment on a long-term basis. Our productivity has been miserable. For the 20 years after World War II, annual productivity gains were in excess of 3 per cent; over the last 10 years, only 1-1/2 per cent; and recently, even worse. It's apparent that we cannot break the cycle of wages chasing prices and prices chasing wages unless we once again return to a higher level of productivity gains. Germany spends over 15 per cent of GNP on business fixed investment; Japan over 20 per cent; the United States 8 or 9 per cent. We've been underspending for too long. We need to develop Government policies that will give incentives to business to build up its investments to a level of 12 per cent of GNP and to keep this up for at least a decade--in order to re-establish our productive superiority, in order to modernize, in order to become competitive in the world, and in order to renew our technology.

Fourth we need to have a very long-term and substantial effort to build up our exports. I am sure Juanita has talked to you about this. Our exports are critical if we are to offset our dependence upon foreign petroleum until we can shift to indigenous or alternate sources of energy. And while we're going through that long and difficult process, we need a tremendous drive to remove the barrier to exports. Again, to put it in simple targets as we do in business, it seems to me that we need to build up our exports from 6-1/2 per cent of GNP to 10 per cent over 5 to 7 years. You cannot accomplish it overnight. But if we would do that we would not only correct our current account deficit, but we would also have a surplus that would allow us to absorb additional goods from other countries and therefore contribute to a bigger pie for the whole world economy, a contribution that would, I think, both offset problems of unemployment and help in the fight against inflation.

A fifth important element is to have an energy policy that does begin progressively, to reduce our dependence on foreign sources.

Sixth, we need to work far more diligently on removing the regulatory burden on the private sector without giving up some of our justified social objectives.

Seventh, we need a monetary policy that continues to be prudent and steady and stable with a strong firm hand on the money spigot over a long period of time.

And we need, finally, to be committed to assuring that inflation is reduced each and every year by a realistic goal of a half to three quarters of a per cent, until we wring it out completely.

Now those are big orders, but the best way we can possibly achieve our long-term goals is to wipe out inflation. If we are successful in eradicating inflation then we will achieve our basic economic goals of full employment, price stability, and a sound dollar.

I know that in thinking about these problems it's usually popular to point out that the principal culprit is the government: if government would correct its wayward habits and would act properly then all of our problems would be solved. I think there is a good deal of truth to that. But I would like to paraphrase Pogo, who in thinking about the government, said something like this: "I have met the government and he is us." If <u>we</u> do the job, the government will do the job.

Thank you very much.