Remarks

of

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Chairman

Board of Governors of the Federal Reserve System

before the

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Thank you very much, Mr. Chairman, distinguished guests at the dais, and members and guests of the Economic Club, for inviting me to be here this evening. I appreciate this opportunity to discuss some of the issues that are now central to the welfare and progress of this nation, and, indeed, I'm particularly pleased that the discussion could be with this audience, representing as it does the leadership that will determine the future of our country.

In the past, the subject of economics has been notable for its obscurity -- dull and dismal, remote from the interests of the average citizen. All that has changed. Today, economics is gaining remarkable notoriety. Everyone is concerned about the cost of living, interest rates, the value of the dollar, productivity, and even the growth of the money supply. The Federal Reserve, a unique title for a central bank or monetary authority, is becoming better known than ever before. This is so much the better, since it involves an overdue education in understanding the workings of our economy and its relation to meeting our basic needs and objectives. It is so much the worse, in that it comes about because of a dread disease, inflation, that threatens the health and vitality of our system.

When I was nominated to be Chairman of the Federal Reserve a year ago, such was not the case. Inflation was

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a nagging problem, but it was not the principal enemy. All too soon, inflation reemerged with surprising virulence and reasserted itself as a clear and present danger. Inflation quickly became our most important problem. It is interesting that in our lifetimes we have never, in peacetime, suffered significant inflation in America, so all of us are going through a unique experience. We've come to learn that inflation destroys values and incomes. It dries up job-creating investments, impairs the prospects for new housing and other construction, and breeds recessions. It creates financial strains for individuals, businesses, and governments. It causes higher interest rates and disrupts international trade and the stability of the dollar. It is especially hard on the poor, the elderly, and those who live on fixed incomes. In short, inflation is the most destructive force in our economy. It is the cruelest tax of all.

The international value of the dollar is also linked to inflation. The slump of the dollar on foreign exchange markets during the past year can be traced to the record U.S. trade and current account deficits and to the level and persistence of U.S. inflation. The decline of the dollar itself adds to inflationary pressures as

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the goods we import cost more and competitive constraints on domestic producers are reduced. The United States has a special responsibility to maintain a sound currency. The dollar is the dominant unit of exchange in international trade and international transactions. It is a principal reserve asset for the world's monetary system. The dollar, therefore, plays a key role in the health and progress of the world economy and, in our own self-interest, we need a sound dollar to avoid disruptions in our patterns of international trade, as well as to dampen inflationary pressures here at home. The program announced last November represented a forceful response to assure a stable dollar.

Inflationary forces within the U.S. economy have been building up over the past dozen years. The seeds of inflation were planted in the late '60's, when large government deficits were maintained at a time of very high demand. When inflation persisted through the economic downturn of 1970, direct wage and price controls were imposed. They proved to be both inequitable and ineffective. With controls holding down the lid, the U.S. economy was stimulated, building up a head of steam in the kettle. Later, when the lid -- wage and price controls -- was removed, the steam blew off in the form of explosive inflation.

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During the same period, the fixed exchange rate system broke down. The entire industrial world experienced a simultaneous boom creating shortages in many industrial commodities. Agricultural reserves were exhausted through a combination of higher demand and poor harvests. Following the boycott, oil prices increased five-fold. The result of this sequence of events was double-digit inflation in the United States, for the first time in peacetime, and in many other countries. These shocks, as might be predicted, were followed by a recession around the world. Recession was especially severe in the United States, but recovery has also been strong. The rate of inflation slowed somewhat in the United States as commodity prices tumbled. But, looking back, the underlying rate of inflation declined only a little. It began to increase again as the recovery proceeded into 1978 with greater utilization of productive resources.

In the face of resurging and persistent inflation, the United States has moved progressively to mobilize a full arsenal of weapons to carry on a war against inflation. Let me outline briefly some of the components of that arsenal. First, fiscal policy; second, incomes policy; third, reduction in regulatory burden; fourth, revitalization of productivity; fifth, a balance in our international

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accounts; and sixth, a monetary policy which complements and supports the other elements.

In the case of fiscal policy, there has been a major shift toward tighter control over Federal spending and a corresponding reduction of deficits. The original Federal government financial plan for the fiscal year 1979, which began last October, was modified after it was submitted to reduce spending and to cut back on proposed tax reductions so as to reduce the projected deficit by $22 billion. The Administration and the Congress demonstrated their resolve to fight inflation by taking this unprecedented, but highly commendable, action. As a result, the Federal deficit will drop from $49 billion in FY-78 to $38 billion in FY-79. The President has just submitted his new budget which reduces the deficit further to $29 billion for FY-80, even though this will mean some cuts in current service levels.

The application of increased Federal restraint must have a further goal, and that is to reduce the relative role of government in the American economy. The emerging pattern shows a steady reduction in the relative role of government expenditures, from the present 22% of gross national product to the 20% range as soon as possible. Potentially this would release $60 to $70

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billion to the private sector, where the cumulative effect of individual decisions by people and by businesses will have a more beneficial impact than the monolithic decisions of the central government.

A second weapon in the fight against inflation is an incomes policy. Last October 24, the President introduced a broad-based program calling for voluntary moderation in wage and price actions, establishing specific standards for wages and prices, and offering a series of incentives for compliance. There is no intention on the part of anyone in the government to re-introduce mandatory controls, because they did prove to be inequitable and ineffective. But the program is a basis for seeking the cooperation of both management and labor in accepting restraint, in their own self-interest, as a contribution toward curbing inflation and thus enhancing the prospects for real gains in compensation and in profits.

As this program has developed, most of the leading corporations have pledged to comply. The recent settlement with the oil, chemical and atomic workers was in compliance with the standards and represents a responsible and encouraging sign. With further private support from

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both management and labor, the President's program can help in bridging us over until the time when fundamental fiscal and monetary policy can break the cycle of inflation.

A third policy concerns the reduction in regulatory burdens, which have added to costs, and thus to prices, without commensurate public benefits. Unwinding unnecessary regulatory burdens will take time and may require some redirection through legislative as well as administrative action. While the short-term effects of this action on reducing inflation may be moderate, it is critical in the long run to unleash the American enterprise system from unneeded and costly restraints on its flexibility, responsiveness, and creative capacities. The Administration has indicated its commitment to this objective, and it is vital to our long-term welfare.

The fourth component is directed toward revitalizing productivity. During the first twenty years after World War II, productivity gains in the United States were the highest in the world, running about 3-1/3 per cent per year. This helped counter inflationary pressures, even while Americans were achieving annual increases in real income. But for the past ten years we have fallen woefully behind, and productivity gains have been running at less than 2 per cent -- even lower for the last five

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years. One of the principal reasons for this is that the United States has lagged seriously behind other industrial nations in replenishing its capital stock. In Germany, 15 per cent of gross national product is devoted to business fixed investment; in Japan, over 20 per cent; in the United States, 8 to 10 per cent. No wonder we're falling behind in modernization, in technology, in productivity, in our capacity to compete in the world.

The tax legislation passed by the Congress included provisions to liberalize the investment tax credit and to promote capital formation, but much more will need to be done if we are to reestablish our position as the leading industrial nation of the world. This issue needs to be addressed urgently.

A fifth weapon has been the marshalling of policies and resources to deal with the international situation. The decline of the dollar in foreign exchange markets over the past year is clearly linked to the U.S. inflation problem and to our current account deficit. And the decline of the dollar has, at the same time, been one of the causes of rising inflation in the United States, as essential imports have cost more and competition from imports on

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domestically produced goods has been reduced. One of the contributing factors to our trade deficit, and hence to our current account deficit, has been U.S. requirements for imported oil. The problem has its origins in history. For a long time, America was a vast, sparsely populated continent with seemingly inexhaustible supplies of inexpensive energy. A great industrial nation was built, in part, by taking advantage of cheap energy, sometimes in substitution for capital or labor. But in time, with ever increasing demand, the limitation of supplies became a reality. Now the United States must be engaged for a number of years in converting its industrial facilities, transportation equipment, housing stock, and commercial establishments to more energy efficient and more energy conserving methods of doing business. We also must convert to local supplies of energy.

Because the United States is a heterogeneous nation, with many regional differences as between energy producing and consuming areas, it has been particularly difficult to hammer out national energy policies. Important progress was made through the energy legislation enacted by the 95th Congress, which deals, among other things, with conservation, conversion to coal and natural gas. The new

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Natural Gas Law creates a single national market where previously there were two markets: the higher priced intrastate market, with its surplus; and the regulated, lower priced interstate market, with short or uncertain supplies, particularly for industrial users. The immediate consequence of the new law is that now there are abundant supplies, nationally, of natural gas which will immediately reduce the requirements for imported oil and liquid natural gas. Attention now needs to be directed to bringing market forces to play with respect to oil, and toward the alternatives for moving domestic oil prices to world levels and thus incentivizing development of and production from indigenous sources.

Mention has been made already of the factors that influenced the decline of the dollar over the past year. By late October, the lower exchange value of the dollar could not be explained by fundamental developments, such as inflation or current account positions. In view of this circumstance, and of the importance of the dollar as a world currency, the Administration and the Federal Reserve, in cooperation with the governments and central banks of Germany, Switzerland and Japan, decided to act forcefully to correct the excessive depreciation of the dollar. The measures announced on November 1 included a

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substantial increase in foreign currency resources immediately available for U.S. intervention, expanded gold sales, and a further sharp tightening of U.S. monetary policy.

The monetary action included a 1 per cent increase in the discount rate, the largest increase since a similar move during the bank crisis in the early 1930's. It also included a 2 per cent increase in the reserve requirements on large certificates of deposit. The marshalling of foreign currency resources of intervention by the U.S., in addition to resources for direct intervention by other countries' central banks, involved an initial total of $30 billion in Deutsche marks, Swiss francs and Japanese yen, mobilized through Federal Reserve swaps, U.S. Treasury drawings on the International Monetary Fund, and sale of Special Drawing Rights. Also included was a U.S. Treasury program for sale of foreign currency denominated obligations, which represented an historic step for the United States and opened up a new opportunity for acquiring foreign currencies without expanding the money supplies of other nations. First sales of DM and Swiss franc obligations have now been completed very successfully. The United States, certainly the Federal Reserve, is firmly committed to its dollar support program, and we will play an active role in helping to achieve and maintain international monetary stability.

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Finally, a word about monetary policy in this great war against inflation. Of course, monetary policy must play a key role. The Federal Reserve, therefore, has moved early and progressively to apply monetary restraint and reduce the growth of money and credit . . . .

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