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Lessons to be Learned

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As I thought about possible topics for my remarks this evening, it seemed to me that it might be useful to reflect with you on the lessons to be learned from my own experience as a central banker, now in my 34th year with the Federal Reserve. I have not known Byers Miller over all of those years, but for most of them, and have always valued his friendship and wisdom and am most appreciative of this opportunity to be with him and all of you this evening. That holds true especially for your president, Ray Kolb, who is another old Fed friend from many years back.

When I was in Richmond, Virginia, long ago with Byers, one of my associates at the Fed Bank there owned an early postwar model MG sportscar. In those days the owners' manuals were more complete than they are now and one of the key passages in the MG manual read as follows: "If a strange noise should emanate from under the bonnet (hood), do not proceed in the hopes that matters will right themselves."

In some 34 years of experience dealing with problems of monetary policy, international financial affairs, and economic stabilization, I have come to recognize that this principle has a much broader application than merely automobile maintenance and repair. Time and time again the problems that have developed in the economics sphere, though they may have seemed transitory at the outset, have in fact proved to have great durability. Nowhere has this been more true than with the balance-of-payments problem of the United States, which has persisted now for close to 15 years, and with inflation, a recurrent and serious problem throughout this postwar period and inextricably interwoven with our balance of payments.

What lessons have we learned over the past decade or more in dealing with these two vital and interrelated issues?

The most recent noise under the hood of the international monetary system--the floating of the British pound--points, in my judgment, clearly and unequivocally to the first and most important lesson of all: there is no substitute for sound domestic economic policies in achieving or maintaining external equilibrium. For the United States the principle translates into what is now almost a truism, namely, that there are no quick and easy solutions to our balance-of-payments problem -- yet its resolution is essential to the restoration of a durable international monetary system.

Over the years we have tended, with indifferent success, to deal with our external deficits by measures designed largely to provide temporary relief rather than correcting a structural problem.

Restrictions on capital outflows began with the Interest Equalization Tax in 1963, when rising capital outflows were eroding the gains that were then occurring in the trade balance. But instead of being temporary the restrictions had to be intensified as the trade balance deteriorated following the peak surplus of $7 billion in 1964. And as extended time and again, and amended, such restrictions have become less effective and less relevant. They illustrate the paradox of the United States position. Efforts by such means to shore up the current balance-of-payments position induce a relaxation in efforts toward the correction of a basic disequilibrium.

We have sought quotas on imports of various types of goods to relieve pressure on particular industries, and this suggests that pressures for quotas may again intensify if trade deficits persist.

We have negotiated financial arrangements with some countries covering their claims on our reserves.

And we have tied economic aid to purchases in the U.S., among many other actions of the same type.

None of these actions were successful in reversing the deteriorating trend in our balance of payments which led to the drastic actions of last August. On the other hand, the realignment of exchange rates achieved in December, through the Smithsonian Agreement, should in time make a major contribution to improving our basic position.

Today, some people look for an easy escape in the name of "greater flexibility" of exchange rates. Certainly the old adage that "steel that bends is stronger than iron that breaks" is true of the international monetary system as well. In the past, unnecessary rigidity crept into the fixed rate system which had served the world so well in the post-Bretton Woods period. But the obvious need for prompter moves to avert long overdue changes, with possible disruptive consequences, does not warrant a swing of the pendulum completely in the other direction. And such a swing cannot, despite the wishful thinking of many of its proponents, in truth promise to be a substitute for sound economic policies or to provide relief from the constraints of achieving domestic stability.

There frequently appears to be a lack of awareness among policy makers at home and abroad that the U.S. in fact is subject to a stronger discipline, that of the determination of the American people to enjoy the fruits of relative price stability. This discipline holds forth the promise that we will in fact reap the potential advantage from the Smithsonian Agreement. Against the diminishing success of other palliatives aimed at reducing our balance of payments, it points to a second and related lesson, namely that the United States must follow effective internal stabilization policies and win the battle of inflation. This is not mere rhetoric. For our failure to control inflation after the mid-1960's was a key element in the rapid deterioration of our balance of payments. It would be an oversimplification to describe changes in world competitiveness in terms of relative price changes alone, and there is no wholly satisfactory way of comparing trends in costs and prices among countries. But I believe we can trace the course of events fairly well by using a measure of unit labor costs in manufacturing. On that yardstick, the U.S. performance in the 1950's was better than all other industrial countries except Italy and Japan. And from 1960 through 1964 unit labor costs in the United States were stable while in European industrial countries, and even in Japan, they rose sharply. But in the period from 1965 through 1970 unit labor costs in the United States rose nearly 4 per cent annually, against one per cent for Japan and with other major competitors in between. This relative shift in the behavior of production costs was a major factor accelerating the dramatic decline in our trade balance from a surplus of almost $7 billion in 1964 to a deficit last year of nearly $3 billion.

The inflation during the latter half of the 1960's had significant adverse effects on the U.S. domestic economy as well as on our balance of payments. There is no simple way of measuring the social costs that result when costs and prices are out of control for an extended period. But during this period (specifically the years 1966-70) our productivity gain ran far below its long-run growth rate. By 1970 the cumulative shortfall was roughly 6 per cent in the index of output per manhour -- the equivalent of about $54 billion of annual product at today's prices.

That is the loss for just one year -- 1970 -- due to the shortfall in productivity growth. There were also losses before 1970 -- and after. Indeed, once a nation falls behind its potential level of productivity, it may take years to regain that potential, and the amounts lost in the years between can, of course, never be recovered.

It would be wrong to argue that the productivity slowdown was attributable solely to inflation. There were other factors -- including the gradual change that has been taking place in the age structure of the labor force. But the renewal of productivity gains in 1971 at rates above the long-term average suggests that factors peculiar to the 1966-70 period were predominantly responsible. And I would suggest that a major identifiable factor was our rate of inflation.

A third lesson emerges from the second, namely that the U.S. cannot by its own policies ensure the correction of our balance of payments and the viability of the international monetary system over the longer run. Continuing cooperative efforts among the countries most concerned are essential. Other countries have assumed a relatively more important role in the functioning of the system; they have to share, and in fact have been sharing, in the burden of adjustment. As we move forward in restructuring the system, there is a clear need to take account of the underlying economic realities and particularly the more nearly equal distribution of economic power in the world. It has taken us a long time to learn to accept, or at least to recognize or acknowledge, the long-term shift in the economic balance of power and competitiveness away from the United States and toward other industrial countries -- most notably Japan and Germany.

That shift is the culmination of the resurgence of the Common Market and other industrial countries following World War II from what was virtually economic paralysis at the end of the war. These countries -- with our assistance -- worked hard to raise the real incomes of their people and in so doing increased their importance in world trade. The most spectacular rise was achieved by Japan. Her share of world exports of manufactures was only 1-1/2 per cent in 1950. It increased to nearly 8 per cent last year. Similarly, Germany's share of world exports rose from under 4 per cent in 1950 to 12-1/2 per cent last year. In contrast, the U.S. share in world trade was 18 per cent in 1950 and had declined to 14 per cent last year.

Looking back, then, we may have misjudged for many years the nature of our persistent balance-of-payments deficits because we failed to take into account the extent to which fundamental economic relationships were changing. Looking forward, we need to take account of the greater economic weight of other industrial countries, both individually and in combination, to give more voice to the less developed countries, to break down trade barriers and avoid inward-looking economic blocs, and to provide a more orderly process for the provision of world liquidity. We need to make the international monetary system more responsive to the inevitable differences that emerge between the economies of various countries. Prompter adjustments to avoid the build-up of large imbalances are essential.

Let us not make the mistake, however, of assuming that achieving the necessary somewhat greater flexibility of exchange rates would for any length of time give us or any other country an easy escape from the external pressures to maintain a rising productivity curve or from the internal pressures of excess aggregate demand. A declining exchange value of the currency that is forced by rapid increases in domestic costs and prices simply adds further to costs of production as import prices rise -- making it still more difficult to regain control of the economy. While we need exchange rate adaptability to match changes in underlying economic circumstances, we should be wary of any tendency to believe that domestic producers should be sheltered from competition by the help of rising import costs, for the same exchange rate changes will also adversely affect consumers and raise production costs even further.

The lesson that we cannot solve our balance of payments without the cooperation of others leads to a corollary lesson that it would be self-destructive for us or other countries to attempt to solve external problems by discriminatory restrictions on trade. All countries must work to break down trade barriers. Transitory constraints may be required from time to time but only to cushion the adjustments needed, not to block off needed adjustments. For example, our 10 per cent surcharge from last August to December could easily have led to retaliatory action abroad, delayed necessary adjustments at home, and unnecessarily penalized a large group of third countries. But it was removed in time.

Another lesson to be learned is that ways and means must be found to cope with the volatile and potentially massive flows of short-term capital in a present world in which mobility of funds has been insured by the improvements in communication and facilities for the transfer of funds. Again, the most recent crisis points out how far the international monetary system can be subjected to unnecessary stresses and strains by movements of speculative funds. But we have not yet learned how to deal with such flows. Short-term capital flows were responsible for much of the disorder in international markets in the 1930's; they are now immensely greater in size, and movements are facilitated by the greater sophistication of market participants and technical facilities that allow nearly instantaneous shifts between markets and from one currency to another. The question of how to deal with the short-term flows is not easily answered. One possibility, which we now see widely employed, is to try to dry them up by controls -- controls against inflows and controls against outflows. But, frankly, all experience with this instrument suggests that it is difficult for a small country with a compact financial market, and may be impossible for a large country rich in financial institutions and multi-lateral corporations. Nevertheless, I believe we need to keep searching for more effective and concerted use of barriers to these flows when they are serving no other purpose than to hedge against a change in exchange rate which these very flows may artificially induce. An alternative, which we also need to explore, is the possibilities for an agreed procedure among central banks which would allow for more absorption, or sterilized financing, of such flows, possibly with some sharing of costs or losses.

Up to this point, I have been talking primarily about the noises under the hood of the international monetary machine, especially those reflecting our own inflation and balance-of-payments problems. But this does not mean that there have been no knocks under the hood of the domestic economic machine and, in particular, our domestic financial system. Quite the contrary. The so-called credit crunch of 1966 and the near crisis conditions that existed in some sectors of U.S. financial markets during the spring and summer of 1970 are still much too vivid for us to ignore the need for more than just a cleaner carburetor in domestic monetary machinery. What are the main lessons to be learned on the domestic monetary side of things?

First of all, there is the clear lesson that more needs to be done in the area of restructuring our financial system so that public policies to combat inflation can work more effectively. The Federal Reserve's own study on housing, submitted to the Congress last year, was one effort to make constructive proposals. And over the years there have been a number of studies by public (including Presidentially appointed) and private bodies of various aspects of our financial markets.

While our financial markets could be better structured to withstand the variations in credit flows that may be required in the effort to keep inflation under control, a more flexible use of fiscal policy than in the past would reduce the extent to which financial markets may be subject to substantial shifts in the amount and direction of savings and credit flows. A more flexible fiscal policy would also reduce the likelihood that demand pressures on the economy would cumulate to the point where they become difficult if not impossible to control without undesired side-effects. Such a danger point tends to be reached when demand pressures are so pervasive and last so long that the attitudes of wage earners and others in society are influenced by expectations that inflation will continue as a way of life.

A flexible fiscal policy requires a responsible attitude toward Federal expenditures and tax policy. I am not talking about continuous budget balancing. There are times when we need planned deficits to help expand the economy. But there also are times when we need surpluses to help calm down the economy. Under inflationary conditions in particular, it is incumbent on the Executive Branch and Congress to see that Governmental outlays are kept under control and to see that tax policy contributes to noninflationary financing of expenditures. What happens in the absence of a truly responsible fiscal policy is well illustrated by the inflationary experience since the mid-1960's. And, against that broad background, the recent and prospective sizable Federal deficits have exacerbated tendencies for inflationary expectations to persist and become more pervasive.

As Chairman Burns said in testifying this morning before the Joint Economic Committee:

> We stand at a crossroads in our fiscal arrangements. Many of our citizens are alarmed by the increasing share of their incomes that is taken away by Federal, State, and local taxes. Meanwhile, Federal expenditures have been rising at a rate well above the growth rate of our national income and product. The

propensity to spend more than we are prepared to finance through taxes is becoming deep-seated and ominous. An early end to Federal deficits is not now in sight. Numerous Federal programs have a huge growth of expenditures built into them and there are proposals presently before the Congress that would raise expenditures by vast amounts in coming years.

The fundamental problem, therefore, is how to regain control over Federal expenditures. I do not think this can be accomplished without departing from our traditional methods of budgetary management.

Among the various possible proposals, as noted by the Chairman, one that would produce immediate beneficial results would be a legislative ceiling on this year's Budget expenditures.

Again, a related lesson is that there is a need to supplement both monetary and fiscal policy once cost-push inflationary pressures have developed.

Once inflationary attitudes pervade the country, it becomes very difficult to bring inflation to a halt. Monetary policy certainly becomes a relatively less effective instrument. To the extent that the inflationary forces begin to come from the cost-push side, the increasing application of monetary restraint becomes more and more likely to lead to unacceptably high levels of unemployment since there is no excess demand to be curtailed. Over time, cost-push inflationary pressures might be contained, but that would be at the expense of high unemployment and unutilized plant capacity.

Keeping wage increases reasonably in line with productivity gains is the key to averting cost-push inflation. The sharp rise in wage rates of the past few years promoted inflationary pressures even in a period when unemployment was running at about 6 per cent of the labor force. Moreover, despite rising prices, the acceleration of wage increases led to a diminishing share of profits relative to income, with the result that business incentives to expand were restrained. Businesses appeared willing to invest in labor saving equipment, and to take other measures to rationalize their organization and make it more efficient, but the confidence required for long-term expansion of plant capacity had been eroded.

The incomes policy announced by the Administration in August of 1971 was vital to efforts to get the economy moving while keeping inflation under control. From my point of view, an incomes policy should have been put into effect earlier; its absence made the job of monetary policy that much more difficult and--since inflationary pressures had moved from the demand-pull to the cost-push side--placed limitations on what could be accomplished to control inflation through public policy.

For an incomes policy to have beneficial, lasting effects, it must help alter the attitudes of labor and business. It must work to remove inflationary psychology from the labor bargaining table and from corporate pricing policy. But over the longer run the fundamental factors in eliminating inflationary psychology are sound fiscal and monetary policies. In a free society we cannot--and would not want to if we could--rely on incomes policy as any more than a transitional program to get us over the rough spots. Moreover, no wage-price policy can be long effective if demand-pull forces of inflation threaten to re-emerge.

A fully effective public policy program to keep inflation under control requires not only responsible and sound fiscal and monetary policies but also, and importantly, measures that will ensure competitiveness in labor and product markets. Only with competition effective can we have some confidence that wage increases will remain roughly in line with productivity gains and that business pricing policies will square with the public interest. Under these conditions, monetary policy can more efficiently fulfill its role of creating the financial conditions that encourage noninflationary economic growth and reasonable equilibrium in our balance of payments.

There is another lesson to be learned when one refers to the efficiency of monetary policy and that is the need for flexibility and adaptability in developing and using our policy instruments. To me, one of the most impressive facets of my own experience with the Federal Reserve System has been to observe it in action as a dynamic, changing organism rather than a static entity. This is true both in the formulation and implementation of monetary policy. We have constantly sought better economic and financial intelligence and better ways of applying it in the decision-making process. We have sought, and are still seeking, ways of improving our main policy instruments -- open market operations, the discount mechanism and reserve requirements.

Flexibility involves, among other things, proper timing -- the ability to change and shade policy promptly as circumstances require. But more than timing, flexibility also requires a lack of rigidity with respect to the financial goals of monetary policy.

In recent years, we at the Federal Reserve have placed somewhat more emphasis than in the past on monetary aggregates in the formulation and effectuation of monetary policy. However, it would be wrong to become rigid in our attitude toward monetary aggregates as a group or to become wedded to a particular aggregate, such as the money supply. There are many and varying definitions of money. We can never be certain how much money -- however defined -- the public wants to hold. The public is continuously shifting into and out of various kinds of assets -- such as demand deposits, time deposits, and savings accounts -- which are money-like in quality; so that we cannot be confined in our analysis to any single definition. And our knowledge about relationships between money and the factors that affect decision making by individuals and business firms -- such as credit availability and cost, prospective income or sales, and over-all liquidity -- is subject to considerable professional debate.

Thus, we must continuously evaluate credit conditions and interest rates themselves to see if they are appropriate to economic circumstances, both domestic and international. While we cannot look at interest rates alone because of the danger, for example, of providing too much new credit and money to the economy if demands for goods and services are expanding more than desired, neither can we be guided by money alone because there is the parallel danger of providing too little new money and credit if we have underestimated how much new cash is required to finance desired expansion.

There is no escape from using judgment in public policy. And it is merely simplistic to base judgments about monetary policy on the behavior of so narrow a variable as the money supply; that seems clear from our past experience.

These and other lessons need to be applied to the full agenda of tasks that remain to be done to curb or, even better, to avoid inflation in the domestic economy, to restore our international competitive position, and to create a more viable structure of international financial relationships. I do not underestimate the magnitude or the complexity of the problems we as a nation must face over the longer run.

Not long ago at breakfast, my six-year old daughter, Whitney, asked me, "How old are you, Daddy?" In order not to frighten her completely, I prevaricated a bit and said, "Oh, around 50." She then asked, "And when I'm around 50, how old will you be?" Again, I said, "I would be near a hundred." She persisted and asked me, "When I'm near a hundred, how old will you be?" To that query, I responded, "You know, Whitney, I think the practical possibilities of either one of us living that long are not very great." She thought for a moment and then looked up at me and said, "Well, we can try, can't we, Daddy?"

As I have thought about the twin problems of balance of payments and inflation and their integral parts in terms of improving U.S. price performance and competitiveness, it sometimes seems to be almost as hopeless a task as that of attaining perpetual youth. But we can and must try.

And I am comforted somewhat by the recent comment attributes to Mrs. Alice Roosevelt Longworth. When congratulated on her seeming eternal youth, she recalled a quotation from "The Spoon River Anthology" that goes like this: "Perhaps after all the secret of perpetual youth is merely arrested development."

This may be equally applicable to the problem we are confronted with today, namely our search for ways to control inflation and bring about external equilibrium and, as far as my remarks are concerned, the role of monetary policy in that search. For the real task of monetary policy, and perhaps the only way it can be truly effective, is in assisting in the arresting process -- in preventing the development of the deep-seated inflationary expectations and spiraling cost pressures that in turn develop a life of their own and are the principal threats to achieving improvement in productivity and competitiveness. Once these developments have been allowed to become self-reinforcing, as was the case in the latter part of the 1960's, monetary policy can play only a lesser role in the much harder task of restoring the sort of basic noninflationary conditions and attitudes conducive to improving our competitive position.

The final lesson, then, is that of humility with respect to the evident limits to the contribution of monetary policy. The job of trying to control inflation, and to right our balance of payments cannot, and must not, be left to monetary policy alone. Indeed we can no longer rely solely on general monetary and fiscal policies designed to influence aggregate demand. There is a constructive role to be played by more direct measures to influence wage rates and commodity prices when costs and prices do not respond sensitively to the balance between demand and supply.

But in closing, I would like to make a confession as well as add a somewhat more optimistic note. In selecting as my topic, "Lessons to be Learned," I confess I was influenced a bit by recent events in the Peanuts comic strip in which Snoopy, after much soul-searching decides to write a book on the subject, "Things I Have Learned After It Was Too Late," beginning with the first chapter on "Never Argue with the Cat Next Door. He is Always Right," with the closing chapter, "A Whole Stack of Memories Will Never Equal One Little Hope." For my part I have more than a little hope that we will win the balance-of-payments and inflation battles. And on both fronts I believe there is room for at least cautious optimism about the near-term outlook.

On the inflation front we do seem to be experiencing some improvements in our record of performance on costs and prices in the U.S. economy. First, productivity gains are on the rise again. Last year the rise in output per manhour in the private non-farm economy rebounded to a 3.7 per cent rate. This year, with real output rising faster an even larger increase is possible. Labor supplies moreover should remain relatively ample through the remainder of this year and on into 1973, given the likelihood of a rather substantial increase in the civilian labor force. Second, the labor cost situation seems somewhat better. Over the first half of this year, for example, average hourly earnings in the private non-farm economy rose at an annual rate of about 5-1/4 per cent, compared with 6-3/4 per cent during the first seven months of 1971. The improvement partly reflects the results of competitive forces dampening the rise in wage rates, but the control program has also had a salutary effect. Third, the price situation also appears a bit brighter. The broadest measure of price performance -- the fixed weight index of prices of all private goods and services in the gross national product -- rose over the first three quarters of last year at an annual rate of about 4-1/2 per cent. In the three most recent quarters, the rate of increase has receded to about 3 per cent. Consumer prices since last August have increased at an annual rate of 2.7 per cent, compared with 3.8 per cent in the first seven months of 1971, and in the last four months the annual rate of increase averaged about 2 per cent.

On the balance-of-payments front, too, while our trade account has been disappointing, especially to those who mistakenly looked for an early benefit from the realignment of exchange rates last December, past experience points to the fact that, while patience is necessary, such large shifts in exchange rates do, over time, produce large favorable shifts in trade and other current account transactions, and in capital flows as well. And even with our trade balance showing little improvement to this point, beginning in mid-March the over-all balance of payments became more favorable due principally to short-term capital inflows. There was, in fact, a balance-of-payments surplus between mid-March and late June when the British pound was floated.

Finally, I think the most hopeful sign of all, however, is the evident concern of the American people with the effects of inflation. They are concerned about the impact of rising costs and prices on the purchasing power of their incomes and on the real value of their savings. They have responded well to the efforts by the Federal Government to take needed steps to halt the wage-price spiral and I am sure would support whatever further steps might prove to be needed. They do not intend to accept less than a full measure of success in this struggle with inflation, nor will we in the monetary policy arena cease trying to do our part.