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Remarks by

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We seem to be well through a period of major readjustment in this country, a readjustment whose roots lie more than a quarter century ago with the inflation induced by the Vietnam war. Budget deficits began to rise, inflation took hold, and currency values became unhinged--and our economic policy apparatus was apparently unprepared to deal effectively with any of these developments.

As inflation accelerated through the 1970s, it appeared to be embarking on an inexorable upward path, which monetary policy was able to block in the early 1980s, but only at a significant cost in economic growth and jobs.

The severe inflation and correspondingly high interest rates of the late 1970s and early 1980s brought to, or pushed over, the edge of bankruptcy a large number of financial institutions that had lent long-term and borrowed short. The inevitable pressures to deregulate the financial system as a solution to the maturity mismatch, coupled with the growing availability of new financial technology, raised the apparent optimal debt-equity ratio of both business and consumers in the 1980s.

From 1984 to 1990 roughly $600 billion of corporate equity was replaced by debt. During the same years mortgage debt on existing homes increased approximately $700 billion, as householders endeavored to leverage the equity in their homes, the prices of which seemed to be on a permanent uptrend.

A burgeoning service sector also created a large increase in the need for office space. Reinforced by favorable tax legislation, the demand for space led to a rapid rise in commercial property asset prices and commercial construction, financed largely by debt. The decline in inflation and interest rates through most of the 1980s renewed a willingness to invest longer term, and rising equity prices, as well as those for physical assets, underscored the expansion.

The trouble encountered by some leveraged buyouts and, later, the unexpected slump in real estate values exposed debt buildups that in retrospect had clearly been excessive. The effort to repair burdened balance sheets in the 1990s has put a damper on spending by many businesses and households suppressing economic growth. Financial institutions, afflicted with heavy loan losses as asset prices fell, tightened their lending standards, exacerbating the economic slowdown. Accordingly, the modest economic advance of the past couple years has been financed unprecedentedly from sources other than financial intermediaries.

We seem now to have come virtually full circle since the destabilizing deficit financing of the Vietnam war. The inflationary pressures that so dominated the economic events of most of the last quarter century appear largely, though not as yet wholly, subdued. Short-term interest rates are back to the levels of the early 1960s. Long-term rates, although at their lowest levels in two decades, do not, at least as yet, reflect the benign view of long-term inflation that prevailed prior to the Vietnam war. I shall return to this issue later.

While much of the strain experienced during the inflationary episodes of the 1970s and the recent bout with excessive debt leverage have been painful, the legacy is not without important benefits. We did, of course, experience the longest peacetime expansion in history during the 1980s. Moreover, much has been learned about economic policy, about what government can and cannot effectively accomplish. Despite disturbing evidence of reregulation in a number of sectors of our economy in recent years, we are still enjoying the demonstrable benefits of a general movement toward freer, more competitive markets that occurred during the 1980s. Indeed, on a much broader scale, the failures of central planning have led to a virtual world-wide acceptance of the competitive market system as the best economic structure for fostering societal well-being.

With tax and regulatory reforms heightening incentives in the 1980s, innovation advanced measurably, especially in computer and telecommunications technologies. In recent years, sophisticated software applications have interacted with rapidly improving hardware technologies to alter profoundly the way we organize the production of goods and services in this country The distressing side of this transition has been significant permanent job losses, as the extensive restructuring of American industry rendered large layers of operations redundant.

The benevolent side of the process may be a dramatic increase in trend productivity which, to many, appears to be on the horizon. It is too early to determine whether the recent surge in output per workhour is a cyclical phenomenon or an early indication that the long-term trend of productivity has already tilted upward. Increased productivity, of course, is the only way to achieve sustained increases in real incomes and standards of living.

At the core of the changing business landscape is the downsizing of economic output, which continues apace. As microprocessors become more powerful, telecommunications more advanced, and physical products slimmed down, the Gross Domestic Product is becoming progressively more conceptual and less physical. Ideas are replacing physical inputs in the production of goods and services. This is an irreversible process and bodes well for accelerating growth in the real values that make up our standard of living.

Indeed, low inflation feeds lower interest rates and costs of capital and thereby spurs innovation and productivity over the long run. But there is mounting evidence that low inflation is also associated with an acceleration in productivity growth in the short run as well. The history of the post-World War II period indicates a significant correlation between low inflation and high productivity growth. Apparently as inflation falls, businesses seeking to increase their profit margins perceive that they can do so only by enhancing efficiency. When inflation is high, the alternative of expanding profit margins by raising prices is more tempting, although the gains usually prove to be only transitory, as wages eventually catch up with the inflation rate. My sense is that, in the recent period, the lack of pricing leverage has once again concentrated the minds of business people on the need to increase productivity; this is one reason to suspect that the current productivity upswing may indeed be more than cyclical. This is another sense in which the post-Vietnam economic experience appears to be running full circle, back to the early 1960s: a period of low inflation and strong productivity growth.

But while such a long-term outlook is increasingly possible, and definitely appealing, it rests to a large extent on the expectation of continued subdued inflation. It is an open question whether we have learned enough to skirt the dangers of budgetary and monetary excess that have triggered past episodes of debilitating inflation.

There certainly appears to be pronounced interest and political support throughout our nation for reining in outsized budget deficits. The President and the Congress are actively engaged in this process as we speak. While the debate is quintessentially political in the best sense of the word, there are nonetheless some economic principles that will affect the outcome.

As I have emphasized in recent weeks before the Congress, according to both the Office of Management and Budget and the Congressional Budget Office, budget outlays under existing law are scheduled to rise at a pace in excess of taxable incomes after 1996. As a consequence, a strategy based on these projections, and designed to narrow or even to contain the deficits as a percent of nominal GDP wholly from the revenue side, would require progressively higher rates of taxation and/or a continuous broadening of the tax base. At some point under such a regime, any economy would stagnate and tax revenues would fall. Accordingly, if long-term deficit reduction is the goal, irrespective of what is enacted on the revenue side, there is no alternative to curbing the growth in spending to below the rate of growth of taxable incomes, or what for the most part amounts to the same thing, nominal GDP.

To be sure, should recent improved productivity growth turn out to be longer lasting, tax receipts would obviously be higher than is currently being projected by either OMB or CBO. But, short of a surge in productivity well beyond what one can credibly anticipate at this point, receipts growth still would fall short of the projected growth in outlays under current law. Moreover, projections of such outlays fail to account for future spending add-ons owing to ongoing congressional deliberations, administrative rulings, and judicial decisions. It is not possible to know in advance which spending programs will be expanded, but we do know that some will. In recent years, current-services outlay estimates have consistently been adjusted upward in response to such technical reestimations of program costs. Indeed, technical reestimates explain a significant part of the failure of the deficit to fall as contemplated at the time of enactment of the Omnibus Budget Reconciliation Act of 1990.

Statistically speaking, the currently projected unsustainable excess rate of growth in mandated federal outlays is concentrated in Medicare and Medicaid, and there is no question that their rates of growth must be slowed if eventual budget balance is to be achieved. But if such a complex process as reform of our medical care system turns out to be especially difficult and drawn out, paring back the growth in other areas of mandated outlays will clearly have to be considered.

While shrinking the long-term budget deficit is doubtless a necessary condition for low inflation, it would not be sufficient: monetary policy also must avoid the excesses of the past.

The interactions of monetary policy with inflation and inflation expectations have become increasingly apparent as a major economic force over the past quarter century.

Through the first two decades of the post-World War II period, these interactions were patently less direct. Savers and investors, firms and households, made economic and financial decisions based on an implicit assumption that inflation over the long run would remain low enough to be inconsequential. There was a sense that our institutional structure and culture, unlike those of many other nations of the world, were inhospitable to inflation. As a consequence, inflation premiums embodied in long-term interest rates were low and effectively capped. Inflation expectations were reasonably impervious to unexpected shifts in the aggregate demand or supply of goods and services.

In those circumstances, monetary policy had far more room to maneuver; monetary policy, for example, could ease aggressively without igniting inflation expectations.

Even during the rise in inflation of the late 1960s and 1970s there was a clear reluctance on the part of investors and others to believe that the inflation being experienced was other than transitory; it was presumed that inflation would eventually retreat to the 1 to 2 percent annual rate that prevailed during the 1950s and the first half of the 1960s. Consequently, long-term interest rates remained contained.

But the dam eventually broke, and the huge losses suffered by bondholders during the 1970s and early 1980s sensitized them to the slightest sign, real or imagined, of rising inflation. At the first indication of an inflationary policy--monetary or fiscal--investors now dump bonds, driving up long-term interest rates. To guard against unexpected losses, investors still demand a considerable premium in bond yields--a premium that affects the environment of monetary policy today.

This heightened sensitivity of investors has affected the way monetary policy has interacted with the economy. To be sure, a stimulative monetary policy can prompt a short-run acceleration of economic activity. But the experience of the 1970s both here and abroad provided convincing evidence that there is no lasting tradeoff between inflation and unemployment; in the long run, easier money buys higher inflation, but no increase in employment. An overly expansionary monetary policy, or even its anticipation, becomes embedded fairly soon in higher inflation expectations and nominal bond yields. Producers quickly incorporate expected cost increases into their own prices, and eventually any increase in output dissipates as inflation rises and any initial decline in long-term nominal interest rates is more than retraced.

The goal of low-to-moderate long-term interest rates is particularly relevant in the current circumstances, in which balance-sheet constraints have been a major--if not the major--drag on the expansion. The halting, but substantial, declines in intermediate- and long-term interest rates that have occurred over the past few years have been the single most important factor encouraging balance-sheet restructuring by households and firms. They also engendered significant reductions in debt service burdens. Monetary policy has played a crucial role in facilitating balance-sheet adjustments, and thus enhancing the sustainability of the expansion. We have eased in measured steps, helping to reassure investors that inflation is likely to remain subdued, thereby fostering the decline in longer-term interest rates.

Recognizing emerging tendencies for the economy to slow, the Federal Reserve began to ease policy in the spring of 1989. In response to the downturn that began in August 1990, we accelerated the decline in short-term interest rates. Last year, we extended our earlier reductions in rates by easing the federal funds rate cumulatively by another percentage point. In addition to lowering interest rates, the Federal Reserve cut reserve requirements last spring for the second time in sixteen months to help pare depository institutions' costs and encourage lending.

Although the easing actions over the past few years, with few exceptions, have been purposefully gradual, cumulatively they have been quite large. Short-term interest rates have been reduced since their 1989 peak by nearly 7 percentage points; looked at differently, short rates have fallen by two-thirds. Nonetheless, some have argued that monetary policy has been too cautious, that short-term rates should have been lowered more sharply or in larger increments.

In my view, these arguments miss the crucial features of our current experience: the sensitivity of inflation expectations and the necessity to work through structural imbalances in order to establish a basis for sustained growth. In these circumstances, monetary policy clearly has a role to play in helping the economy to grow; the process by which monetary policy could contribute, however, has been different in some significant respects from past business cycles. Lower inflation and intermediate- and long-term interest rates are essential to the needed structural adjustments in our economy, and monetary policy thus has given considerable weight to encouraging the downtrend of such rates.

Some have suggested that the decline in inflation permitted more aggressive moves and, had the downward trajectory of short-term interest rates been somewhat steeper, that aggregate demand would have been appreciably stronger. I suspect, however, that the disinflation very likely would not have occurred in the context of an appreciably more stimulative policy, and that such a policy could have led to higher inflation in the next few years. Moreover, such a policy would not have dealt fundamentally with the very real imbalances in our economy that needed to be resolved before sustainable growth could resume. And it would have run the risk of aborting the process of balance-sheet adjustment before it was completed. The credibility of noninflationary policies would have been strained, and longer-term interest rates likely would be higher, inhibiting the restructuring of the balance sheets and reducing the odds on sustainable growth.

Containing, and over time eliminating, inflation is a key element in any strategy to foster maximum sustainable long-run growth of the economy.

Over the past decade or so, our nation has made very substantial progress toward the achievement of price stability, reversing a dangerous upward trend of inflation and inflationary expectations. Last year's increase in the Consumer Price Index, excluding volatile food and energy prices, was the lowest in twenty years and far lower than the debilitating double-digit rates at the close of the 1970s. Price stability does not require that measured inflation literally be zero, but it does require that inflation be low enough that anticipated changes in the general price level are insignificant for economic and financial planning. At current inflation rates, we are quite close to attaining this goal.

Regrettably, the inflation excesses of the 1970s still condition the inflationary expectations of today. Despite little apparent fear of an imminent upsurge in inflation, the very steepness of the Treasury yield curve reflects deep-seated investor concerns that inflation will significantly quicken in the latter part of this decade and beyond. I assume that the problem of our structural budget deficits for the years ahead is a key factor explaining the failure of long-term interest rates fully to follow short-term rates back to their levels of a quarter century ago.

The reasonably flat Treasury yields out a year or more are consistent with an economic environment that does not seem conducive to a near-term reemergence of inflationary pressures. The recent firming in some materials prices probably has more to do with improving demand and the restoration of more normal levels of profit margins than to early signals of sustained inflationary pressures. This hypothesis suggests that, when margins are restored, the rate of material price increases should slow down. Moreover, labor markets remain slack. The recent firming of wages reported in the March payroll data may reflect nothing more than excess overtime costs of cleanup following the late winter storms. And certainly the evident rise in productivity has, to date, persuasively contained increases in unit labor costs.

Finally, it is difficult to envision inflationary pressures intensifying in the context of a still partially infirmed financial system and exceptionally subdued credit expansion, the tinder of past inflationary episodes.

But because the old economic and financial verities have not served us particularly well in understanding the American economy in recent years, we need to be especially vigilant not to be mesmerized by the current tranquility of the inflationary environment. I cannot indicate to you tonight where Federal Reserve policy will head in the weeks and years ahead. I do know that it would be irresponsible for us to dismiss the experience of the post-Vietnam war years and once again allow the destabilizing forces of inflation to undercut economic growth and employment.

Suppressing inflation over the past decade, and more, has obviously not been without cost. To fritter away this substantial accomplishment by failing to contain inflationary forces that may emerge in the future would be folly.

A society's central bank is rarely popular; its role in fostering maximum sustainable long-term economic growth requires it at times to take difficult steps to preserve the value of the currency both domestically and abroad. Such preservation, of necessity, implies inhibitions to inflationary financing whether the initiatives emerge from the private or public sector.

If our financial system is to continue to fund long-term projects--the hallmark of economies offering high living standards--a stable currency and domestic price level are preconditions.