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NEW DIRECTIONS

Remarks by

G. William Miller

Chairman

Board of Governors of the Federal Reserve System

before the

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It is a special pleasure for me to be here today for my first appearance on the West Coast as a member of the Federal Reserve family. However, I'm surprised to be here in this capacity, just as many of you are surprised to see me, because I never expected to be a banker of any kind. And I certainly never expected to be a central banker.

When President Carter announced last December that he would nominate me to be Chairman of the Board of Governors, The Wall Street Journal headlined the story with "William Who?" That was a wonderful headline. It is now my ambition to qualify for a similar headline four years from now. Because if, in four short years, the Chairman of the Federal Reserve is so obscure that no one remembers his name, then inflation will have abated, the dollar will be strong, the stock market will be at new highs, and America will be enjoying an unparalleled period of prosperity.

In other words, I will be forgotten -- but the world will be better off!

Meanwhile, such is not the case and all of us have our work cut out for us. I say, "all of us" because the task ahead is one that requires the involvement of every American, public and private. Each of you has an important stake in the outcome. Each of you has a critical role to play. What happens over the next few years depends as much upon you as upon the President or the Congress or anyone in Washington or in Sacramento. And the need for responsive and responsible action is urgent.

How Our Difficulties Developed

The past dozen years have been characterized by dramatic shocks and discontinuities. The war in Vietnam was divisive. The state of domestic tranquility was interrupted by civil disorders. Failure to pay for that war planted the seeds of inflation. The threat of inflation led to imposition of wage and price controls which proved to be unworkable, inequitable and ineffective. The international monetary system broke down. With wage and price controls holding down the lid, the U.S. economy was reflated and allowed to build up a high-pressure head of steam. When the controls were lifted, the steam blew off producing double-digit inflation and double-digit interest rates.

To compound the difficulties, the oil boycott ushered in a five-fold increase in world petroleum prices. Then the Watergate incident, and its aftermath, led to a general public disaffection with all institutions, public and private. Finally, there was the great recession of 1974-75, with 9 per cent unemployment and the greatest economic distress since the Depression of the 1930's.

Recent Recovery Still Leaves Uncertainties

We are now in the fourth year of economic recovery from those troubled times. The level of prosperity has advanced considerably. Social and political conditions have become more stable. Yet, in the face of progress, there remains nagging uncertainty. This is not because of any lack of agreement on economic goals. There is universal accord that our objectives should be full employment, price stability and a sound dollar.

The uncertainty arises because many have come to question whether those goals can be attained.

I am convinced that America's economic goals can be achieved. The means to do so are at our disposal. All that is required is the will. We should realize that there is a confluence in our individual self interests that compels us to join together in a common effort. Divided, we shall realize none of our goals. United, we shall accomplish them all.

Inflation is Our Most Serious Problem

Inflation is now our most serious domestic problem. It is the number one issue not because it has precedence over the quest for full employment, but because under present circumstances it is the primary obstacle to achieving full employment. Inflation is inextricably linked with unemployment. Our hopes for full employment on a continuing basis depend upon wiping out the virulent disease of inflation.

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, accelerates government spending, 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 disruptive force in our economy today. It is the "cruelest tax" of all.

Perhaps the best way to illustrate the clear and present danger of inflation is to consider the consequences for young people who are graduating this month from America's colleges and universities. If inflation should be permitted to continue at the present annual rate -- expected to be seven per cent or more this year -- then when today's college graduates reach normal retirement age, the dollar they now hold will be worth less than a dime. At age 65, the dollar of today's graduate will be worth less than 10 cents.

We cannot let that happen to our young people -- or to Americans of any age -- or to the world. We simply must prevail.

The Role of the Dollar

The international value of the dollar is also related to inflation. The decline in the dollar since last September can be traced to the record U.S. trade and current account deficits and to the level and persistence of U.S. inflation rates. The decline in the dollar itself adds to inflationary pressures as 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 and stable dollar. It is the currency for most international trade and finance. It is the principal reserve asset for the world's monetary system. The dollar is therefore the key to world economic progress. And in our own self-interest, we need a sound dollar to avoid disruptions in our patterns of international trade and investment and to dampen inflationary pressures here at home.

Energy is an Important Factor

One important factor in all of these considerations is energy. America was fortunate to be able to develop as a nation by utilizing the seemingly boundless resources of a vast, almost unpopulated continent. The availability of abundant and inexpensive energy fueled the growth of a great industrial economy. But, with 6 per cent of the world's population consuming 30 per cent of its energy, it was inevitable that a day of reckoning would come. The forces of supply and demand came into play with a vengeance.

In 1973, the United States paid about $8 billion for imported oil products. Last year, the import bill was $45 billion. This enormous shift contributed to the large U.S. trade deficit and to the pressure on the dollar. The task ahead is to convert our industrial, commercial, residential, transportation and public infrastructures into more energy efficient systems. We need to conserve present energy reserves, to reduce dependence on foreign petroleum, and to change over to alternate, more economic energy sources. This process will certainly take a decade or longer.

Economic Problems Are Interrelated

It is clear that our economic problems are interrelated. Inflation contributes to the decline of the dollar. The decline of the dollar contributes to inflation. Inflation drives up interest rates and breeds recessions which cause unemployment. Unemployment causes large federal deficits which contribute to inflation.

Our task is to break the vicious circle. In endeavoring to do so, we can learn from history, even though the lessons of the immediate past are not encouraging.

Perhaps it is time for us to take new directions to help shape a stronger America and a better world.

Greater Emphasis Needed on Investment

One such new direction would involve a conscious shift in the philosophy behind U.S. economic policy from less emphasis on "demand" or "consumption" management to more attention to "supply" or "investment" management. Let me cite two periods when leading world powers have experienced hyper-inflation.

The first occurred in 16th century Spain. The discovery of the New World gave Spain access to vast amounts of gold and silver. Gold from the new world introduced massive unearned purchasing power into Spain which drove prices up perhaps a thousand per cent or more. That purchasing power did build great palaces and did provide the most elegant life style that had ever been experienced up to that time in Europe. However, the use of resources was for consumption, with little attention to investments for the future. So, by the 17th century, Spain had run through its wealth and was economically barefoot.

Is there a parallel in our 20th century experience? Through the printing presses, there has been a massive creation of unearned money and credit. The United States has built the most affluent nation ever known, with the highest standard of living for the largest number of people. Is this to be another example of overindulgence in consumption? Will we neglect essential investments and deplete our capacity to provide for future generations? Will the legacy of our time be an economic desert?

Reduction of Government Sector

A second new direction would be to shift resources from the public sector to the private sector. The present percentage of our gross national product represented by government spending -- Federal, state and local -- has grown steadily until it may have reached the point of being counter-productive. During the last decade, it has become apparent that government spending does not always produce the desired results -- economically or socially -- and may not be the most effective way of reaching our desired objectives.

Amidst growing disenchantment, a more promising course would be to return more spending decisions to individuals and to businesses, where the cumulative effect of thousands and millions of private initiatives will be more efficient in sustaining and expanding economic progress. America needs to return to greater reliance upon the inherent vitality of the private enterprise system.

New Directions: Eight Points of Strategy

The New Directions for economic policy should include specific strategies and quantitative targets to give all of us a clear picture of where we are going. With such a blueprint, it would be possible to evaluate all proposed policies and actions as to their contribution toward achieving the established goals.

Perhaps this could best be understood by designing a model economy that would represent the ideal condition sought within a reasonable time, perhaps five or six or seven years in the future. Then our economic policies could be directed on a steady course to reach those targets. The components of such a model might include the following:

First, a balanced budget with full employment. With the steps already taken or planned, the budget deficit for fiscal year 1979 is now expected to be $50 billion or less, down from the original $60 billion. The trend should be continued with a reduction to less than $40 billion for FY 1980, to less than $20 billion in 1981 and to a balanced budget in 1982.

Second, the percentage of Federal expenditures should be reduced gradually over a five to seven year period from 22 per cent of GNP to 20 per cent. Even though the Federal Government would still be spending more, such a program would mean Federal spending of $50 to $60 billion less than otherwise would be the case, and these resources could be shifted back to the private sector.

Third, there should be a policy to achieve a substantial increase in business fixed investment. The United States has been neglecting its capital base. We are falling behind other principal nations. Japan spends 21 per cent of its GNP for capital investment, Germany 15 per cent. The United States, 8 or 9 per cent. Over the years, we have fallen behind in our productive capacity, our efficiency, our productivity and our technology. One technique in stimulating more capital investment would be a substantial liberalization of depreciation guidelines -- with a five year write-off for productive equipment -- so that cash flows from risky investments would justify the investment.

Later, there could be the possibility of examining other capital formation areas for stimulating private investors and for encouraging entrepreneurship. But overall, the goal should be over the five or seven year period to increase capital spending from 9 per cent to 12 per cent of GNP.

Fourth, we should have an active policy with respect to housing, which in many past cyclical periods has fallen substantially below demand. In the next five years, it would be appropriate to see housing production increase each year by 75,000 to 100,000 units until we reach a level consistent with our housing needs. To the extent that the boom-and-bust housing cycles of the past can be replaced by more stable production, costly bouts of periodic underbuilding and overbuilding will be avoided. As a result, greater efficiency would be achieved in the use of resources in homebuilding and related sectors of the economy.

Even more important, a gradually increasing annual pace of homebuilding over the next 5 years could help to accelerate the slow process of upgrading our Nation's stock of housing -- our most valuable item of private physical wealth. Moreover, an enlarged supply of new dwellings could reduce upward pressures on general housing prices. It could also better accommodate the evolving needs of new households for adequate quarters, and the replacement of older dwellings that no longer conform to the minimum shelter requirements of a dynamic society.

Fifth, there should be a vigorous program to expand exports, with a definite goal over the next five to seven years to increase our exports from 7 per cent of GNP to 10 per cent, in line with secular growth in imports. This would go far in helping to correct the balance of payments deficits which have plagued us for some time and which have undermined the value of the dollar.

Sixth, as the program progresses, and as the capacity to shift resources to the private sector emerges, there would be opportunities for additional tax reductions for individuals consistent with the goal of a balanced budget, and also consistent with the purpose of reducing government expenditures and giving more spending decisions back to people.

Seventh, high priority should be given to a serious and sustained effort of regulatory reform to reduce the unnecessary, costly and inflationary burden of government on people and on businesses.

The Federal Reserve has itself taken an important step in this direction. Early this month, the Board of Governors approved a comprehensive plan for a major review of all our regulations and related interpretations and rules to see where improvements might be made and outdated requirements eliminated. We seek to reduce our own regulatory burden.

And eighth, there should be a definite commitment to reduce inflation on a steady basis, at the rate of one-half to three-quarters of a per cent per year until we reach our goal of price stability, full employment and a sound dollar.

Short and Long Term Responses

These, then, are eight suggestions for New Directions as part of an overall strategy that, if pursued vigorously and continuously, would see us overcome within a reasonable time -- within an attainable period -- the terrible economic disease which now threatens our vitality.

Since I have been in Washington, most of my attention has been directed to short-run problems. The dilemma we face at the Federal Reserve is in trying to react against inflation in the short term, and in trying to shape a coordinated economic policy so that the Federal Reserve and monetary policy is not left to do the job alone. A great deal of progress has been made in that regard. It is encouraging to witness the change of attitudes in Washington and to see the specific concrete steps that have been taken in response to the awakened realization of the clear and present danger of inflation.

But we still face a difficult challenge in the period immediately ahead. In the next few quarters, we must be able to exercise restraint sufficiently to overcome inflationary pressures, but without overdoing it so as to trigger an economic downturn. If we fail, we will face either a period of even more cancerous inflation or a period of recession, or possibly both.

To succeed will require the best skills that can be marshalled from all those who hold responsibilities in the government and from all those who have responsibilities in the private sector.

Overcoming Inflation and Achieving Goals

My message to you tonight is simple: inflation is a terrible problem. We must conquer it. In the short term we have a very difficult task to tread our way through a narrow passage. In the longer run, with a united country, we have the means to achieve our economic goals. And when we do, economic stability, full employment and a sound dollar will not only contribute to our own well being but also will offer the best prospects for peace and prosperity throughout the world.

Thank you.

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