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Remarks by

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In thinking about what to say on this occasion, I inevitably wondered about what economists and rheumatologists could possibly have in common. And, as I thought about it, I decided quite a bit.

For instance, I sense we are both better -- at least so far -- at diagnosis than at cures.

We both observe a certain pattern of pain and remission, but we are much more confident of our ability to explain what has happened than to predict exactly what will happen next.

From time to time, we have both taken heart from the thought that gold, properly used, could help cure our difficulties, only to be ultimately disillusioned.

And despite our years of learning and our efforts at education, we still find our patients and clients longing for relief turning, with distressing frequency, to today's equivalent of snake oil and witchcraft.

But, quite seriously, I at least once removed, know something of the challenges before the Arthritis Foundation, both in supporting pioneering research and in working, day by day, to help individual patients find the care and understanding they need. Compared to that, my own work sometimes seems to deal in impersonal abstractions and a flood of statistics. But in the end, of course, those abstractions and statistics also reflect something of great concern to Americans.

The conduct of economic policy, like medical practice, depends heavily on the attitudes of the people affected. The polls these days, electoral and otherwise, seem to suggest a certain sense of economic well-being. That's understandable. There has been a lot of economic good news over the last 18 months or more; it has looked even better compared to what went on immediately before.

This decade, economically speaking, started in a discouraging -- even frightening -- way. As a nation, we had come to expect that inflation had become a way of life. As we did so, it predictably began to accelerate. People preoccupied with how to beat inflation began to worry more about how to trade their houses for capital gains and about the price of gold than about how to do their jobs a little better. And in that environment, it is not so surprising that productivity growth practically stopped, and so did real increases in income. Once price increases threatened to get out of hand, even the textbook axiom that there was a "trade-off" between a little more inflation and a little less unemployment didn't seem to work. We ended up with more of both.

Events beget reactions. So there was a growing public conviction that something was seriously wrong -- that we had to take steps to deal with inflation and to enhance productivity, even if, in the short run, sudden and painless solutions were not possible. There was a sound instinct that delay would only ultimately entail much heavier costs. And that instinct provided essential public support for needed policy changes.

Part of that found expression in efforts to reduce regulations impairing competition, to restrain public spending, in sizable reductions in tax rates, and in more favorable tax treatment for savings and investment. All of that was designed to help markets work better, and to strengthen incentives to work and work more efficiently. Monetary policy was necessarily assigned a key role to move more aggressively to deal with inflation, using the blunt -- but indispensable -- tool of limiting growth in the money supply.

As those adjustments were made, we went through a period of considerable economic dislocation -- a relatively long and serious recession, with the highest level of unemployment of the postwar period, historically high interest rates, and disconcertingly volatile fluctuations in all kinds of financial markets. We will have to leave to the economic historians the debate about how it all could have been managed a little better -- that will only be relevant if we again permit ourselves to fall prey to inflation. But there has already been ample experience, here and abroad, to draw the central lesson that we can't live comfortably with inflation, and that once entrenched, there is no simple and painless way to deal with it. And with that lesson so fresh in mind, we should be wise enough, for a long time ahead, to make sure that accelerating inflation does not recur.

I'm not going to argue this evening that we have, as yet, slain the inflationary dragon. But it is fair to suggest that, for the first time in a long while, it's on the defensive. And I think that once we got down to the serious business of controlling inflation, the gains have been greater -- and come faster -- than many thought possible.

Measured by consumer prices, inflation has been running at a rate of little more than four percent a year, still far from satisfactory, but lower than in more than a decade. Wholesale prices of goods have been rising very little -- not at all for six months. That is a good omen that, for the time being, prices at the retail level will remain under control.

The first progress toward lower inflation occurred during a deep recession. There was a natural inclination to be skeptical. We had seen that before; it would be only a cyclical phenomena; just wait, inflation would, like arthritis pain, come back with a change in the weather.

In that light, the most encouraging news is that, after two years of strong expansion, the trend has remained better. And as it has, there have been signs that success can help breed further success.

For instance, as expectations of inflation have slowly diminished, labor doesn't have to fight so hard for increasing wage settlements simply to stay ahead of the game. That helps keep costs under control, and in turn reinforces the disinflationary process.

As prospects for greater price stability have improved, the chronic weakness of the dollar internationally during much of the 1970's has been dramatically reversed, indeed to the point of concern that the competitive pressure of imports on some of our most important manufacturing industries may be excessive. Whatever the precise optimum level of the dollar in relation to other currencies, the message is clear that the renewed emphasis on productivity and efficiency born in the adversity of recession must be maintained and reinforced.

And, as confidence gradually strengthens in our ability to restore reasonable price stability -- a confidence that can be earned and kept only by sustained performance -- we will have put in place one of the basic prerequisites for interest rates returning to, and staying at, the much lower levels we have enjoyed historically.

All of this, as you know, has been accompanied over the past two years by the strongest peacetime economic expansion in many years. Both employment -- with 6-1/2 million new jobs created over the past two years -- and average real incomes have gained. Consumption has been high, but investment has also surged. After-tax profits, relative to GNP, are as high as in some time.

But, of course, all this started from a low level. With unemployment still well above 7 percent, we still have a considerable distance to go before we can be satisfied that we are operating at levels close to our true potential. With continued sizable increases in investment, we should be able to keep our physical capital in line with needs. And more competitive markets will help keep prices under control.

But I would fail to be in character, as a central banker and practitioner of what has been called the dismal science, if I did not emphasize to you that, despite all these recent gains, all is not right in the economic state of the United States. We face some tough policy choices --

tough politically and tough economically. Unless they are resolved soon, and resolved satisfactorily, all those bright prospects will be in jeopardy.

The current economic news has been full of reports of a sharp slowing in the rate of economic growth during the summer and early fall. In one sense, that is not surprising; the pause comes hard upon an exceptionally sharp rate of increase in the Gross National Product, at a rate of some 8-1/2 percent, during the first half of the year. The barrage of attention, in this media age, to every twist and turn in the economy should not obscure the simple fact that it's not in the nature of the economic beast to move forward, quarter by quarter, with military precision.

A sharp slowing in growth for a time during an expansion period is in fact historically common, typically related to temporary imbalances in inventories following a period of rapid accumulation and temporary fluctuations in consumption. Something of that sort seems to be at work this fall.

Continuing growth in income and employment and relatively strong investment plans are reassuring signs for the future. The decided decline in interest rates as the growth rate has slowed should help support both housing and investment, and the related easing of pressures on bank reserve positions by the Federal Reserve will help keep money and credit growing.

But the question persists -- is that all there is to it? Is something more fundamental at work that could lead to more serious difficulties?

We don't have to look far for a possible culprit. Fed mainly by an enormous increase in imports, our international trade deficit reached a new high of about $130 billion at an annual rate during the summer.

Throughout the expansion period, the trade balance has been deteriorating, and so has, in parallel, our overall external current account, which measures imports and exports of all goods and services. Since late 1982, the current account deficit has increased by almost $100 billion to an annual rate in the neighborhood of $120 billion during the third quarter.

When we import more goods and services than we export, we <u>must</u> pay for it in the only way we can -- by borrowing capital from abroad in the same amount. For the time being, that has not been difficult. Relatively high interest rates, growing confidence in our economic prospects, and political stability have all acted as a magnet for foreign funds. But I must also point out that the United States is importing capital so fast that the largest and richest country in the world is well on its way to becoming the largest international debtor as well.

The growing trade deficit, and the related capital inflow, have some highly significant implications. For one thing, we as a country have been consuming significantly more than we have been producing. The GNP -- a measure of production -- has risen by about 12 percent in real terms over the past two years. Domestic spending has risen appreciably faster, by more than 15 percent. In essence, a lot of demand generated in this country has flowed abroad, generating production and income in other countries. We didn't feel it much, in overall terms, while our own production was expanding so rapidly. But it made a very noticeable impact last quarter, when domestic demand continued to expand at the relatively rapid rate of more than 5-1/2 percent, while GNP growth slipped to a rate of only about 2 percent.

Both industrialized and developing countries abroad have benefitted from our growing markets. That has been a crucially important contribution to world economic health at a time of high unemployment and halting recovery in Europe and when many Latin American countries have been struggling to get their own finances and external accounts in order. From our own standpoint, the ample supply of foreign goods in our markets has certainly benefitted the consumer and helped to keep inflation under control. What may be less understood is that the massive capital inflow has, directly or indirectly, helped enormously in maintaining a reasonable balance in our capital markets during a period of record Federal budget deficits.

The simple fact is demands on our savings -- from business investment, from housing, and from the Federal deficits -- currently exceed what American individuals, businesses, and state and local government pension funds are willing to save by an amount equivalent to about 3 percent of the GNP. That shortfall is, in effect, being covered by drawing on the savings of other countries; the net financial inflow in the third quarter appeared to be running at a rate of some $120 billion a year.

Let me put the point another way. I am sure many people, worried about the budget deficit a year or more ago, feared that deficits would "crowd out," as the phrase goes, domestic housing and investment as economic recovery took hold. There was understandable concern that interest rates would be under very strong pressure -- that there wouldn't be enough money to finance both rising investment needs and a Federal deficit in the range of $175-$200 billion at the same time. "Something" would have to give.

Well, yes and no. That analysis, focused primarily on the U.S. potential to save, failed to take account of the sharp increase in the inflow of capital from abroad. Interest rates have indeed been high, relative to most other industrialized countries, and foreign capital has freely flowed into our markets in amounts adequate to enable us to maintain rapid growth in business investment and reasonable levels of housing. That capital inflow was, at the same time, necessarily accompanied by a growing trade deficit. That deficit reflects lost markets for our exporters or manufacturers competing with imports. Those internationally oriented businesses have been the ones "crowded out" -- but that process was not recognized so clearly simply because those industries are widely dispersed, because the chain of causation is indirect, and because the economy has been expanding so rapidly. And, of course, we will have to pay interest on those foreign borrowings for many years.

Given all the apparent advantages -- the stimulus to world growth and adjustment, lower interest rates domestically than would otherwise have been possible, and the benefits to consumers of relatively low priced foreign goods -- why, it might be asked, should we be so concerned?

For a simple reason. Strong as the United States is, and encouraging as is our progress toward price stability and greater productivity, borrowing so much abroad, and running so large a trade deficit, is not sustainable indefinitely.

For one thing, there is a political as well as economic dimension. So large a deficit understandably intensifies, among affected industries, the already strong pressures for protection. A lot rides on the ability of the Administration and the Congress to contain those pressures, for yielding here will certainly be matched, and more, by retaliation abroad. I can think of no scenario more conducive to undermining world economic growth, and more particularly the prospects for the poorer countries already struggling with debt problems. At the same time, it would provide a strong inflationary impetus.

Economically, protectionist measures are a diversion from the underlying problem. Suppose we somehow succeeded, in short order, in sharply reducing the trade deficit and its counterpart, our borrowing from abroad? Then, how would we finance our Federal deficit? What would be the implications for interest rates -- and thus for housing and investment?

The hard reality is that, for the moment, we are addicted to foreign borrowings to reconcile our deficit and our investment needs with our limited propensity to save at home. Yet, we can't count indefinitely on the capital inflow -- among other things, growth needed in other countries requires that they employ more of their savings at home. At some point as our debts rise, confidence could be undermined. Surely, the constructive approach is to act to end the addiction by moving promptly and effectively to reduce the budget deficit, restoring better balance to our domestic capital markets, encouraging lower interest rates, and reducing the pressures on internationally oriented business.

Our relative success in dealing with inflation and achieving growth, by encouraging confidence in our outlook, has fortunately provided time for taking action. But I fear those same successes might lead to an unwarranted sense of relaxation among our citizens. There is an understandable reluctance to face promptly and directly those difficult decisions on spending cuts -- and if those cuts cannot be made in sufficient amounts, to raise revenues -- necessary to reduce the deficit to tolerable levels and eventual balance. In the best of circumstances, the effort will take months to begin and years to implement. To wait longer will not escape the ultimate need. What it would do is make our capital markets, our interest rates, and our exchange rate hostage to events beyond our control, at the risk of undercutting so much of what has been achieved toward sustaining growth and price stability.

I noted earlier that interest rates have fallen appreciably in recent weeks, helping to support prospects for growth. The Federal Reserve, through its monetary policies, has the responsibility for assuring adequate growth in money and liquidity in the economy to support orderly growth in demand over time, in line with our potential. We intend to meet that responsibility. Moreover, with the dollar so strong internationally, and with inflationary trends more favorable, I believe we have more flexibility in the conduct of policy than for some time, without raising alarms about a new inflationary surge.

But I must emphasize just as strongly what monetary policy cannot do -- why the flexibility we have needs to be exercised with great care and prudence.

The creation of money cannot remedy the underlying imbalance in our domestic capital markets related to the enormous Federal deficits. Money creation cannot reduce our dependence on foreign capital so long as that domestic imbalance persists. Nor in the circumstances can it prevent the seepage of rising demand abroad, instead of to U.S. producers.

Indeed, the only result of trying to substitute money creation for real savings would be to restimulate inflation and inflationary expectations, undercutting all that has been achieved, and ultimately driving interest rates higher, not lower. And those risks would only be multiplied should we, in our actions, inadvertently undermine the confidence that attracts capital from abroad at tolerable interest rates.

My thesis tonight is a simple one. We have come a long way toward restoring the prospects for price stability and for sustained growth. The benefits have flowed throughout the world, not just to the United States. But we have already delayed too long in facing up to a fundamental imbalance -- reflected in those related budgetary and trade deficits -- that left untended, poses a great threat for the future.

The current pause in economic growth need be no more than that. But it should be warning enough that this is no time to bask idly in the warmth of past progress, at the plain risk that, instead of controlling our own economic destiny, we fall prey to crisis and dislocations.

There are responsibilities aplenty for others: for business and labor to continue working together to improve efficiency, to contain costs, and to innovate; for other nations, in Europe and elsewhere, to stimulate their own growth so that so much of the responsibility for maintaining a healthy world economy does not fall on the United States alone; for heavily indebted countries to build upon the progress they have made to get their own finances more completely in order. And there are encouraging signs in all those areas.

But there is simply no escape for appropriate action by the United States as well -- too much rests upon our ability to conduct prudent and disciplined monetary and fiscal policies.

The record of the past two years seems to me to provide dramatic evidence of the benefits that flow from facing up to problems that once seemed almost insurmountable. With the same exercise of will and foresight, we will be able to look back upon the current pause as simply part of the transition to more stable and sustained growth.

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