For release on delivery
3:30 P.M., E.D.T.
Thursday, June 6, 1985

Address by

Paul A. Volcker

Chairman, Board of Governors of the Federal Reserve System

before the

Harvard University Alumni Association

Cambridge, Massachusetts

June 6, 1985

President Bok, Harvard Alumni and Alumnae, Members of the Faculty, Graduates and Their Families, Ladies and Gentlemen:

It is no easy task for one invited to address this distinguished assemblage to decide on an appropriate subject. I was still agonizing over the matter when I came across an article in the Wall Street Journal about economics at Harvard. I won't vouch for its accuracy, but it made two points.

The first was that economics had become the most popular area of concentration, partly because it appealed to corporate recruiters.

That brought to mind the experience of a Washington colleague who recently participated in a Harvard seminar. His taxi driver, sensing it was his first visit, volunteered to point out the sights. But the only buildings he singled out were the Business School. My friend asked the driver why he was so preoccupied with the Business School when Harvard had such a long and proud history long before the Business School even existed. The driver turned around and said, "Mister, that's where the tips are."

The second reason cited in the Wall Street Journal wasn't much more comforting to me. It said economics was easy.

Well, if making money and simplicity are the relevant criteria, the article raised a few questions about my own career. The challenge before me today seemed clear.

Have things really changed that much from the time I spent at Harvard? To check my memory, I went to the library to see what had happened the week I received my degree here in 1951. Time magazine wasn't really much help -- its cover was a picture of the President of Yale. So I immediately switched to the New York Times. Its lead story was about the Secretary of the Treasury warning Western European countries their currencies were out of line -- that is, they were way too high!

But you didn't have to read very far to sense a more profound difference in attitudes. Sure, there were enormous problems -- Korea was unnerving, Europe had only begun its rebuilding after World War II, and new countries in Africa and Asia were just emerging with uncertain prospects. But through it all, there was a sense that the United States was in control of its own destiny, and the catalyst for action worldwide. When we sent out signals, others listened.

Here at Harvard, the new Keynesian faith that we had the tools for defeating the business cycle -- mainly by manipulating the Federal budget -- was being actively propagated. If that might involve a little inflation to ensure growth -- well, so be it. After all, we'd never had a really serious peacetime inflation; the Great Depression was fresh in everyone's mind; and the prime interest rate was all of 2-1/2 percent. After the catastrophe of the early 1930's, the financial system was newly protected by Federal insurance and other programs.

More broadly, there was a sense that government, rather than being part of the problem, could provide solutions. From this very platform, General Marshall had articulated a way by which America could place its enormous resources behind concerted European recovery. At Harvard, as at other leading universities, many of the best and the brightest looked toward government as providing a worthwhile and challenging career.

I suppose those attitudes culminated in the mid-1960's. We could look back on an unrivaled period of prosperity and growth, not just in the United States, but elsewhere. Unemployment was low throughout the industrialized world. Inflation still seemed a relatively minor problem, even if there were some flutterings of concern as it rose all the way to 3 percent or so as the Vietnam War heated up. We talked confidently of prospects for economic "take-off" of the developing world, and of new frontiers and a great society at home.

I well remember President Kennedy's celebrated commencement address at Yale that caught the intellectual spirit of the times. He argued forcibly that old economic ideologies and slogans were dead or dying. We needed dispassionate, informed debate about evident problems -- unemployment, inflation, budget deficits, currency values, and the rest. The problems were complex and the experts might differ. But that technical debate about practical problems should not be encrusted with stereotypes or mythologies -- such as inevitable links between budget deficits and inflation or the presumed dangers of any increases in government spending.

In effect, my Harvard classroom of 1950 had become national policy. It all seemed sensible enough.

But I also remember, as a then Treasury official in the 1960's, feeling vaguely uneasy. The "technical debate" to which the President referred in fact spanned a substantial range of opinion, rooted in quite different visions of the risks and opportunities before us. More important, I wonder if, in all the technical debate, we didn't lose sight of the critical importance of some fixed principles to help guide the conduct of economic policy.

Certainly, within a decade or so, there was a sense that we had lost our way.

No sooner had we begun to take economic growth for granted than unemployment began trending higher; by the end of the 1970's, productivity practically stopped growing at all.

We got used to inflation, but it didn't seem to stimulate the economy; instead it accelerated to the point we counted on it in our business and private decisions.

We freed ourselves from the "discipline" of fixed exchange rates, only to find large shifts in international currency values could themselves bring new uncertainties and problems in economic management.

Sharp changes in domestic interest rates and financial markets reflected the same sense of pervasive uncertainty, and suggested something in our policies had gone wrong.

Obviously, there has recently been good news as well. The pattern of accelerating inflation in the industrial world has now been broken, and fears of renewed acceleration have at least been dissipated. In this country, we have enjoyed a strong expansion since 1982. Our growth has helped encourage some expansion abroad. Many developing countries, in far more difficult circumstances than we, are coping courageously with their problems of embedded inflation and massive debt, and some of them should now be able to look forward to renewed growth.

More broadly, our political stability is still the envy of the world. There is a renewed spirit of hope and innovation. Indeed, against all the evidence of renewed vigor, I might be accused of falling into that syndrome of a central banker -- as H.L. Mencken once said of Puritans, we have a haunting fear that someone, someplace may be happy.

So let me stipulate that out of difficulty we now have an opportunity -- probably the best opportunity in a generation -- to help lead the world into a new period of sustained growth and stability. We again have something upon which to build. But we have to seize that opportunity. Time is short and the obstacles are evident.

We all know about the massive deficit in our Federal budget -- a deficit that would surely have boggled the imagination of President Kennedy when he defended, more than 20 years ago, the idea that in some circumstances a deficit was appropriate.

The pressures of government finance on our capital markets are tolerable only because we have been able freely to draw upon massive amounts of capital from abroad -- a significant drain on <u>their</u> savings. Even so, our interest rates remain historically high, and the capital inflow is necessarily matched by an enormous flow of imports, squeezing our manufacturers, miners and farmers.

We continue to build more new offices than we can occupy; we've become expert in trading all kinds of financial assets and companies; we build hotels, attend conventions, and travel at home and abroad in unprecedented amounts -- but all the while productivity still lags.

We spend our days issuing debt and retiring equity -- both in record volume -- and then we spend our evenings raising each other's eyebrows with gossip about signs of stress in the financial system.

We rail at government inefficiency and intrusion in our markets -- while we call upon the same government to protect our interests, our industry and our financial institutions.

And the best of our young gravitate toward Wall Street instead of Washington, our state houses or our courthouses. Or, perhaps more accurately, a great many of them do end up in Washington -- to run a lobby or represent a client.

Those internal contradictions are evidence enough of tension and trouble. And to a substantial degree they are echoed and mirrored in imbalances in the rest of the world.

There are 20 million unemployed in Europe, with no clear prospect of really significant reduction. New democracies in Latin America have found themselves on the edge of hyper-inflation, compounding their difficulties in raising living standards. In Africa and elsewhere, a sustained process of growth has never really started.

I am convinced the problems are amenable to practical solutions. Indeed, on an intellectual level, the broad outline of a consensus seems clear enough. Tighten up the budget fast. That should reduce our dependence on capital inflows and help create the conditions for lower interest rates. For the first time in decades, we have a program for a more rational tax system. Europe and Japan can encourage more "home grown" growth. We can all support the efforts of the developing world to make the needed adjustments. All of that should help produce a better alignment of exchange rates.

At that level, economics does look easy.

The part that is hard is converting that vague intellectual consensus into effective action -- and that's not a technical problem. It's a problem of the governing process. It's the challenge of reconciling our individual interests into a coherent whole. It's recognizing that we need strong and consistent signals from Government -- in effect, clear and enforced rules of the road -- for the market place to produce its magic in the form of stability and growth.

The lessons of economic history suggest to me that our success or failure in approaching the practical problems will be dependent on the degree to which we respect some broad guiding principles. Their precise application in particular circumstances will always be debated. But they are important precisely because they provide some fixed points of reference for the technical debate.

After all our experience, here and abroad, a sense of price stability surely must rank as one of those principles. I don't mean we can or should achieve every year some arbitrary statistical measure of zero -- today we have sensitive commodity prices falling, industrial producer prices close to unchanged, and consumer prices still rising at four percent a year or more. My point is simply that in conducting our affairs, we should be able to assume the general level of prices won't change over relevant planning horizons by significant amounts in one direction or another.

That may sound radical to a generation brought up to expect inflation. And I know it was fashionable here and elsewhere, a generation ago, for economists to argue that a "little" inflation wasn't necessarily a bad thing. Businessmen and homebuyers would be pleasantly surprised to find their products or assets worth a little more, and the economy would be stimulated -- or so the argument went.

But, that was a theory born in depression. It doesn't turn out that way once inflation is anticipated as a way of life. Then the process accelerates, the distortions become greater, and productivity declines. Nor does the solution of some economists -- indexation of taxes, wages, and interest rates fundamentally help. In the end, it cures nothing and seems to speed up the process.

We in the United States have had only one prolonged period of accelerating peacetime inflation -- in the 1970's. By the standards of some countries it did not reach extreme levels. But it didn't mean a stronger economy -- quite the reverse. The public properly was aroused to the point of supporting a strong anti-inflationary program.

Now, the more extreme concerns about accelerating inflation are quiescent. But the scars remain in a trail of uneconomic investments, financial strains, and lingering doubts about future price prospects.

Some are tempted to seek an answer to our current economic problem by just another drink from the same inflationary bottle -- just a little sip, of course. But then who could trust a commitment to keep it small -- and what good would it really do us?

The issue is critical not just for the United States alone. The dollar, like it or not, serves as the principal trading currency for the world and as an important store of value. There is no effective substitute available. How can we build a stable international system on an unstable currency -- and how could we lead politically as well as economically?

Nor is the question purely economic. Governments are created, and find their legitimacy, in providing certain collective functions -- the national defense, internal security, the provision of due process, and the protection of individual freedom. They provide the common unit of account and means of payment, and with that, it seems to me, goes the obligation for maintaining its stability.

The obligation of a government to issue the currency and maintain its stability is obviously crucial for a central bank. I don't mean to suggest that every decision on monetary policy can or must be directed solely toward achieving price stability as rapidly as feasible, oblivious to all other economic circumstances of the day, or that we can rely on theorizing about a fixed relation between the money supply and prices to govern every policy decision. I do mean that each of those decisions will need to weigh in the balance its potential effects on inflation, with the clear objective of returning to, and maintaining, stability over time.

There was, for instance, no inconsistency in my mind between a continuing priority concern about inflation and our recent decision to, in the jargon, "ease money" by lowering the discount rate. That decision took place under particular circumstances -- a strong dollar, ample capacity, and slow growth, all of which tend to reduce inflationary pressures. The sensitivity of some to any action that could be interpreted as inflationary is an understandable, if mistaken, heritage of the absence of effective consistent governmental policies to deal with inflation over years. One reward of a record of greater stability -- and a credible commitment to maintain that stability -- will in fact be greater operational flexibility for the monetary authorities.

Sophisticated economists spent a long time educating us that a balanced budget is not always appropriate and that deficits aren't always inflationary -- it all depends on circumstances. We learned well -- too well.

I'm not going to take the time to repeat all the analysis that points toward the urgency of reducing the budget deficit today. Suffice it to say that the deficits are a major factor accounting for the lopsided nature of the present expansion -- pouring out purchasing power on the one hand, while straining world capital markets and the financial system on the other. And, at the same time, it helps keep inflationary expectations alive, and the accumulating interest compounds burdens into the future. Those are not circumstances with which monetary policy alone can deal. It's time for action.

A second area where a sense of lasting commitment seems to me essential involves clear recognition that our destiny must be found in the context of an open world economy. It's still an oddity of elementary American economics texts that international economics is relegated to the back of the book, with the implication the topic can be dropped if the semester isn't long enough. But there really are no separate compartments of "domestic" and "international" economics; as Gertrude Stein might have said, economics is economics is economics.

The arguments for a liberal trading order have always been strong, even when sailing ships took months to cross the oceans and foreign travel was a rare occurrence. Today, with communications instantaneous, with jet planes filling the skies, with business and financial institutions operating across international boundaries as a matter of course, we would forget the international implications of our policies at our peril.

The issue is, again, more than economic. If we have a vision of a flourishing western economic world, providing the opportunity and growth that is a counterpart of our political ideals, then we had better recognize our mutual dependencies from the start, and seek our prosperity in the context of that of others. Once before at a time of difficulty, when we were still emerging as a world power, we in effect tried to opt out by raising high tariff walls. The results in the 1930's should be warning enough.

Yet, the pressures for protectionism are again strong and growing. That's understandable against the background of the massive trade imbalance. We rightly complain about the trade restrictions of others. But, of course, we have in one area after another compromised the liberal trading ideal ourselves.

There are more constructive ways to approach the problem. Most of all, we have to face up to the fact that our trade deficit and exchange rate problems in substantial measure grow out of contradictions in our own economic policies. Some of our trading partners, certainly Japan, need to face up to problems that, in important ways, are the mirror image of our own -- undue reliance on trade surpluses.

Instead of shrinking into a trading shell, with all the risks of retaliation and divisiveness, we can again take the offense by leading the world into a new round of multilateral trade negotiations seeking a global bargain to deal with existing restrictions. That, of course, is precisely the direction the Administration is wisely trying to lead.

As a nation, we have been increasingly niggardly in our support for the international financial institutions -- the World Bank, the Inter-American Development Bank and others -- that far-sighted American leadership brought into being. Those institutions are challenged as never before, and they need our active support and commitment.

We can hardly blind ourselves to the fact that exchange rates, through the floating period, have become more volatile rather than less, increasingly distorting trade and financial transactions. No doubt the erratic -- to put it mildly -- movements in exchange rates reflect in substantial part those policy imbalances and uncertainties to which I have already referred. If the volatility persists in a context of better international equilibrium, we will have to reexamine with a fresh mind whether ways cannot be found, in a cooperative international setting, to encourage greater stability.

The third area I will touch upon briefly is less concrete, but maybe it's the most important. We have an enormous talent for adapting new information and communications technology to business practices and financial markets. These days we have a market for taking a financial position one way or another almost instantaneously on practically anything, all justified on the basis of sophisticated arguments about facilitating preferred investment strategies or hedging risks. But it all raises the question of whether in the process we haven't lost sight of some of the basic qualities that must underlie the stability and continuity of any market.

Financial crisis was a recurrent feature of the American economic landscape in the 19th and early 20th centuries. That is why we have developed an armory of instruments -- the Federal Reserve, the FDIC, and the FSLIC -- to provide a kind of "safety net" to help assure that inevitable isolated failures or strains do not infect the entire system.

In the aftermath of the last great crisis in the 1930's, that kind of Federal support was hardly needed. The natural bent was to be conservative and banks and businesses were both highly liquid and amply capitalized.

But today we have a new generation. We spent our formative years when the strength of the financial system, and the institutions within it, began to be taken for granted.

We came to count on inflation. More leverage, less liquidity and riskier assets could be rationalized -- particularly if it could be assumed that the "Government" would protect the depositor. In that environment, some of the old canons of prudent lending and fiduciary behavior seemed less relevant. And if one has never experienced a crisis of confidence, it was hard to remember that, whatever the urgent competitive pressure to grow and to produce this year's profit, confidence is the most precious asset of any financial institution.

Now, in a time of stress, we have been reminded once again of the relevance of some of those old standards. The Federal "safety net," to be sure, holds strong. But it doesn't by itself ensure confidence in every institution, or protect the stockholder of a bank or savings and loan, or guarantee against dishonesty. And there is renewed recognition that Federal protections have a price -- that a government that visibly bears much of the ultimate risk will insist on its responsibility to exercise strong supervision and regulation.

There has to be a better way than counting on bureaucrats to do so much of the job.

I wonder, over there in the Business School, and in its sister institutions, whether they take enough time to teach the lessons of financial crises -- including how many business reputations have been irretrievably tarnished or worse when competitive pressures or simple greed have led owners or managers to undercut acceptable standards. If not, recent experience seems to be providing rich material for a new case book -- one that illustrates that, in the last analysis, the effective operation of a market system rests on the mutual trust that can only be nurtured by a strong sense of business integrity and fiduciary responsibility. I wonder, too, if all our accountants and lawyers, in serving their clients' interests, are always as sensitive as they should be to their professional responsibilities, designed to protect the public at large.

Maybe all of this sounds like a central banker reverting to type -- preaching to others about their responsibilities. But I won't apologize.

My own alma mater since the days of President Wilson -- I am referring to his days as President of Princeton, of course -- has had as its motto: "In the nation's service." I know that may sound trite these days, but it still says something to me about what education should be all about. I know generations of Harvard men and women, consciously or subconsciously, have shared that tradition.

I also sense one aspect is less strong today -- a willingness to make a lasting commitment to a career in government itself. That strikes me as unfortunate -- unfortunate from the standpoint of effective government, which must rely on a core of dedicated civil servants and experienced legislators capable of understanding the great issues of our time. I'd like to think that it's unfortunate, too, from the standpoint of those missing what can be a satisfying and exciting career.

I sense some of the reasons why government service as a career is weakened, and we ought to deal with them. In the end, it's a matter of respect -- for the role of government and those who work in it -- the kind of thing that should make a Cambridge cab driver sit up and take notice when he passes the Kennedy School.

In the end, in our country, the responsibility of government is to foster a climate of opportunity -- an environment in which enterprise, and ingenuity, and personal initiative will flourish. We can't afford to lose those traditional American values of "know how" and "can do."

My point is those qualities, in the end, are supposed to work toward bettering the lot, not just of ourselves and our families, but of our communities -- local, national, and global.

They will do that only if our acquisitive instincts are confined within certain accepted principles of law and policy. In economic terms, amid the diversity of our individual efforts, we should be able to count on an overall framework of stability and continuity. That framework has to extend to our relations with other free nations. It demands a sense of personal responsibility and integrity rooted in a larger national purpose.

I've talked about economics, but it's not the technical economics of the classroom. My concern is with economics in practice, as a part of the larger human experience, with all its vagaries, and with economics as a responsibility of government, with all its implications for decision making through a political process.

In that sense, I suspect there is as much or more to learn in reading history or the classics, or learning about other cultures, as in the study of economics itself -- and I know those disciplines are not neglected here.

We will succeed not because our business leaders or the Congress took the equivalent of Economics 10; they can call on a lot of PhD's for the technical advice. Rather, they will need a larger vision that encompasses a sense of human frailties as well as human potential; we will need to realize we can't be in business just for ourselves; we need to recognize that our individual and national interests are inextricably tied up with others.

Out of economic adversity, we now have new opportunities. Let's make the most of them.

****