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Remarks of

Arthur F. Burns

Chairman, Board of Governors of the Federal Reserve System

at

Chancellor Helmut Schmidt's Dinner

honoring

Dr. Karl Klasen

on the occasion of his retirement as

President of the Deutsche Bundesbank

Bonn, Germany

May 11, 1977

I am deeply honored, Mr. Chancellor, that you invited me to join this distinguished audience in paying tribute to Karl Klasen.

This occasion has very special meaning for me, inasmuch as Karl Klasen and I have headed our respective central banks over almost precisely the same span of time, each of us having begun service in early 1970.

The period since then has been one of the most eventful in the annals of international finance, and that inevitably has involved frequent and close contact between the two of us.

Our seven years of collaboration have left with me a deep appreciation of the talent and the intellectual integrity which Karl Klasen possesses. I shall miss his official counsel, and yet I count myself fortunate in having been able so often in the past to avail myself of the wisdom and the warm supportive friendship of such a colleague.

I have no difficulty in singling out Karl Klasen's premier achievement as President of the Bundesbank. That has been his determined, unwavering endeavor to foster understanding that there can be no durable prosperity, either in the Federal

Republic or in the world community at large, if inflation is not controlled more effectively than it has been. Karl Klasen's skillful articulation of that truth -- and the bold actions he has taken to give it meaning -- place him squarely in the great tradition of responsible financial leadership so continuously evident in your country since Dr. Erhard's currency reform of 1948.

The Federal Republic's achievement -- under the guidance of men such as Dr. Klasen -- in dealing with inflation more successfully than any other major country has not been lost on an observant world. By your example, others know what can be done where intelligence, determination, and persistence prevail. At this critical juncture in the worldwide struggle against inflation, your achievement is a powerful counterweight to any mood of resignation or defeatism.

Indeed, I am inclined to think that the intellectual climate around much of the globe is slowly changing in a positive way. Only a few short years ago expansionist convictions and policies were in ascendancy almost everywhere, the simple creed being that governmental budget deficits and easy money were safe and effective stimuli whenever an economy failed

to perform at its full potential. Country after country -- mine included -- has been learning the hard way that economic matters are far more complex, and -- what is especially promising -- policies are beginning to be modified accordingly.

The British Prime Minister has summarized the bankruptcy of mechanical Keynesianism perhaps more effectively than anyone else. "We used to think," he said in addressing the British Labor Party Conference in Blackpool last September, "that you could just spend your way out of recession . . . I tell you in all candor," he continued, "that that option no longer exists, and that insofar as it ever did exist, it worked by injecting inflation into the economy. And each time that happened the average level of unemployment has risen. Higher inflation, followed by higher unemployment. That is the history of the last twenty years."

Those words of Mr. Callaghan's are remarkably perceptive. Though directed to Britain's special problems, they have broad applicability throughout the world. They capture the essential truth that policies for stimulating employment on which we have relied in the past -- such as budget deficits and easy credit -- do not work well in an environment that has become highly sensitive to inflationary

fears and expectations. In such an environment, the consuming public in its apprehension about the future will tend to raise its saving rate and thus may frustrate governmental policies aimed at stimulating the economy. Businessmen, too, having learned that profits can erode quickly when inflation is not effectively contained, will tend to become more cautious about undertaking new projects. Mr. Callaghan thus put his finger on the vital point: inflation is the key global problem with which we must cope if we are to regain a lasting prosperity.

Conventional thinking about stabilization policies is inadequate and out of date. Our quest must be for new policies tailored to the need for coping with inflation and unemployment simultaneously. Our approach almost certainly must be less aggregative in its orientation than it has been. More and more, we need to focus on particular structural impediments to increased economic activity and to work at building a social consensus that leads to responsible price and wage behavior by private parties. This does not necessarily mean that we must forswear all use of conventional devices in dealing with unemployment. But to the extent that such tools are employed, they must be used more judiciously than has

been characteristic of the past. Policy makers everywhere must become alert to the need for prompt reaction if signs emerge that excessive stimulation is occurring. President Carter's recent decision to withdraw his proposal for a tax rebate in the face of evidence that the tempo of economic activity in the United States was accelerating more rapidly than had been expected is illustrative of precisely the kind of flexibility in economic policy making that has become essential.

A very general shortcoming of the 1972-74 period -- compounding the oil trauma of that time -- was the slowness of policy makers in many countries in appreciating just how rapidly pressures were mounting on available resources. The consequence was that they permitted inflation to run totally out of control. When the distortions that arose in the process eventually culminated in the worst recession in a generation, the shock to the psychology of both consumers and businessmen was profound. The blow was particularly severe because so few of the current generation of business managers had experienced an economic decline of comparable severity. They had, indeed, been tutored to believe that the

business cycle as it once existed was dead -- that any recession that might occur would prove to be brief and mild, because of the countercyclical weapons possessed by modern governments.

Here in Germany you were wise enough in 1972 and 1973 to take relatively prompt moderating action on both the fiscal and monetary fronts, a fact that goes a long way in explaining, I believe, the comparatively favorable price experience you are now enjoying. But in many other countries the response was tardy, creating extremely vulnerable conditions that continue even now to plague recovery efforts.

Moderation in the pursuit of economic growth is particularly crucial if a much-needed revitalization of capital formation is to occur in the global economy. In the United States, business investment, although accelerating now, has lagged conspicuously so far in the current cyclical expansion relative to its behavior in earlier recoveries. And experience in the United States appears to be representative of what is happening in many other countries. This is a worrisome development because it is weakening the general recovery pattern and also because it suggests the distinct possibility that a condition of inadequate capacity could develop at a later stage of this expansion.

The present lag in capital formation can be traced to various causal factors, but two are of preponderant significance. One is the substantial residue of caution that lingers on among businessmen because of the rude discovery that the business cycle is still very much alive. Inflation worries -- more specifically, apprehension about the degree to which inflation will be controlled -- constitute the second major inhibiting influence on capital spending in industrial countries. Forward planning simply cannot proceed rationally in an environment in which business managers are unable to assess cost and profit prospects with any confidence over the long time horizons that are frequently involved in new investment projects. Inflation raises the risk premiums that businessmen attach to new undertakings; and the higher those risk premiums become, the more likely it is that the volume of investment will be depressed.

Fortunately, there are now numerous signs of an emerging consensus internationally that greater price stability is a key requisite to the achievement of sustainable economic growth and lower unemployment. Last autumn's Communiqué of the Interim Committee of the International Monetary Fund -- urging as it did that industrial nations not only concern themselves with inflation

but actually give it priority attention in their economic policies provided striking testimony to the changing attitude of policy makers. Such emphasis would have been unthinkable in the days when the expansionist creed was in vogue. This new understanding of causal linkage between inflation and unemployment is reflected in the Communiqué just issued upon completion of the London Summit meeting. Expressions of intent accomplish nothing of themselves, of course, but it is of great significance that major governments have at last come to perceive the appropriate direction in which they should be moving.

Because excessive creation of money, historically, has always been associated with inflation, it also is of great significance, I believe, that more countries are coming to experiment with new techniques for achieving better control over monetary expansion. Here, too, the Federal Republic can rightfully claim to have played a pioneering role. The Bundesbank, acting in December 1974, became the first central bank to publicly announce an explicit target for monetary expansion in the coming year. The Federal Reserve

System shortly followed the Bundesbank in making public its monetary projections, and a number of other countries have since then done so as well.

One key value of monetary growth targets is that they force both central bankers and private parties to think more systematically than they otherwise might about the amount of inflation that is being financed at any given time. Our longer-term objective within the Federal Reserve, and I believe the like applies to the Bundesbank, is to achieve a rate of growth in monetary aggregates that is ultimately consistent with stability of the general price level. In the United States, we are, of course, a long way from that goal; and as a practical matter, we cannot move to it rapidly because of the risk of deflecting the economy from its present path of recovery. But it is helpful in our continuing monetary policy deliberations in the United States to have set our sights on what we need to achieve, and during the past two years we have in fact adjusted our growth ranges for monetary expansion gradually but persistently downward. In short, I believe, that such growth targets provide a meaningful framework for fostering monetary discipline, and it is my hope that more and more countries will follow the German initiative.

The serious inflation of recent years has had pernicious effects not only within individual countries; beyond that, it has greatly complicated the task of maintaining orderly international relations.

I am aware, of course, that many people ascribe the present condition of serious payments imbalance among countries and the related bouts of unease in foreign-exchange markets almost exclusively to the burden of higher oil prices. But troublesome as the oil shock has been, it by no means fully explains the payments stresses that presently exist. The fact is that the troublesome payments deficits of many countries, both industrial and less developed, can be traced in large measure to extensive social-welfare and development programs undertaken in the early 1970's and financed by heavy governmental borrowing, often directly from central banks. Even when the internal troubles resulting from inflation were aggravated by the oil burden, there was little or no adjustment of economic policies in numerous instances. Faced with the political difficulties of gaining acceptance of the stringent measures required to restrain inflation and achieve energy conservation, many countries opted instead to borrow heavily from private external sources. Generally speaking, such borrowing entailed no obligation on the

borrower to effect adjustments in the policies that had given rise to the need for special financing.

What is clearly required now is a financial environment in which countries needing to borrow will have less opportunity to do so if they are reluctant to reform their economic policies. Adjustment efforts of many countries must be intensified, so as to reduce their abnormally large deficits. To that end, private lenders need to understand the importance of taking greater initiative on their own in insisting that countries desiring to borrow commit themselves to meaningful stabilization goals; they also must avoid letting themselves be used as sources of funds by countries seeking to circumvent IMF discipline. This is a time that calls for especially close coordination of the efforts of private lenders and the IMF in the interest of seeing to it that international debt creation proceed prudently and that adjustment policies are intensified.

In particular, so that countries needing to borrow have greater inducement to submit to Fund stabilization prescriptions, it has become clear that the Fund's lending capacity should be enlarged and that it should have added flexibility to make loans whose size is not limited by the quota structure. This has been agreed to in principle both by the IMF's Interim Committee and the London Summit conferees, and early implementation of a

special lending facility can now be anticipated. This facility will be established on the sound principle that loans will become available only when an applicant country has agreed to pursue effective economic stabilization policies.

In focusing, as I have, on the need for adjustment by countries whose external position has been weakened by loose financial practices or by failure to adapt realistically to the burden of higher fuel costs, I do not mean to suggest that they alone have adjustment obligations. Countries enjoying payments surpluses have responsibilities as well, both the OPEC group and others.

Certainly, the non-OPEC countries as a group cannot go on indefinitely with payments deficits vis-à-vis the oil producers, totaling \$40 billion or so a year. That would entail a serious risk of irreparable damage to the international economy. To the extent, therefore, that non-OPEC nations find ways to cut oil imports or to enlarge sales to oil producers, it is vitally important that the members of OPEC not try to compensate for any resulting slippage in their surpluses by a new round of oil-price increases.

And, just as clearly, the non-OPEC surplus countries too must contribute to the international adjustment process. Here, though, I think the progress that has already been made is sometimes not fully appreciated. The rapidity with which the

large U.S. current-account surplus of two years ago has wilted away is worth noting. And here in the Federal Republic, your current-account surplus has fallen from about \$10 billion in 1974 to a moderate level currently, thus reflecting a more rapid rise in imports of goods and services than in exports. You have reason to take pride in your record of responsibility toward your trading partners, especially in the degree of willingness you have shown in letting the value of the mark appreciate -- an appreciation that in 1976 alone totaled some 15 per cent.

I recognize that the appreciation of the mark in foreign exchange markets has entailed political risks in the Federal Republic. But your policy has been enlightened in terms of international needs, and I believe it has also been wise domestically in helping to consolidate the hard-won progress you have achieved in curbing inflation.

The Federal Republic has been fortunate indeed in having leaders of the vision of Chancellor Schmidt and Dr. Klagenberg to serve it in the troubled and turbulent times in which we live. And it is a stroke of good fortune that a man of Otmar Emminger's experience and character stands ready to assume the presidency of the Bundesbank. I join

you all in wishing Dr. Emminger, whom I have had the privilege of knowing for a quarter century, every success in continuing the Federal Republic's struggle for a durable prosperity. And I have no doubt that he will meet the challenge he now faces, provided he keeps firmly in mind Dr. Klasen's great lesson to his countrymen: that monetary order is the backbone of a Nation and that an independent central bank is essential to such order.

In closing, I want to put my good friend and colleague, Dr. Klasen, on notice that I expect to call on him frequently for guidance and support. My wife joins me, Karl, in wishing you and your wonderful family many years of good health and personal fulfillment.