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PROGRESS IN THE FIGHT AGAINST INFLATION

Remarks by

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at

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Two years ago this month, the Federal Reserve set forth on a course of monetary policy designed to increase our chances of ending the inflation that has plagued our country for nearly two decades. Tonight, I want to give you a progress report on the struggle to regain stable prices, to lower interest rates, and to create a more stable and prosperous economy.

To state my conclusions at the outset, I think we are making progress -- substantial progress -- in reducing inflation. Moreover, the prospects are encouraging for a further decline in inflation during 1982. The price we are paying to achieve these results is, however, extremely high. Interest rates have risen to painful levels, and some sectors of the economy are suffering enormous anguish. There is now an urgent need for prompt action to relieve financial markets of the pressures from continuing huge deficits in the Federal budget, so that businesses and individuals can meet their needs for credit at reasonable interest rates.

October 6, 1979 marked an historic event in the history of monetary policy in the United States. On that day, the Federal Reserve announced that it would henceforth conduct its monetary policy operations with an eye to providing a supply of reserves to the banking system consistent with a long-term slowdown in the rate of monetary and credit expansion. The counterpart of that decision was to free up interest rates to be determined by the balance between demands for, and supplies of, credit expressed in the money and capital markets.

The relationship between money growth and inflation is very imprecise in the short run. Yet, almost everyone acknowledges that restraint on the expansion of money and credit is an essential ingredient in the fight against inflation.

To an inflation-weary public, the Federal Reserve's announcement came as a welcome development. But a number of questions remained in the minds of ordinary citizens as well as sophisticated financial analysts.

First, did the Federal Reserve really mean what it said? Proclamations of firm intent had been heard previously. Indeed, the Federal Reserve had for a number of previous years announced annual targets for money growth, but often permitted actual money growth to exceed its announced objective.

Second, could targets for money and credit growth be achieved any better under the new procedures than under the old ones? Or were further -- possibly dramatic -- changes required in our monetary system?

Third, would the Federal Reserve persist when the pressures of monetary restraint began to bind? When letters of protest began to pour in from those adversely affected? When the Congressional Record began to fill with angry words of irate Congressmen?

Fourth, would success in slowing the growth of money and credit really achieve the intended result of slowing inflation in a modern and complex economy characterized by inflexible wages and prices -- particularly one in which inflation had been building for nearly a generation, so that inflationary expectations had been deeply entrenched in business and consumer decisions?

Final answers to these questions have yet to be written in the book of history. But the chapters transcribed to date indicate, I believe, that most of the doubts were not well founded.

Let us look, first, at the behavior of some financial variables of major importance. The money supply measure on which the Federal Reserve has focused its principal attention (M1-B, adjusted for the effects of shifts of funds into NOW accounts from sources other than demand deposits) has increased since the fourth quarter of 1979 at an annual rate of between 4-1/2 and 5 percent. In the three years prior to the fourth quarter of 1979, that measure of money balances had increased at an annual rate of around 8 percent.

The growth rate of this measure of money consistent with price stability is probably around 2 percent, or possibly even lower. A further slowing of growth from the average pace of the past two years is therefore needed. But we have accomplished a large and important first step.

The Federal Reserve has thus demonstrated its capacity to control and limit the growth of money over periods that are meaningful from the standpoint of economic performance. It has also begun to convince many citizens of its intentions to stick to its announced course of monetary restraint. Just last week, the Journal of Commerce published the results of a survey of 38 corporate treasurers and financial officers. Only one expected an easing of Federal Reserve policy during the next six months.

Monetary restraint during the past two years has led to a marked deceleration in the growth of private debt. All nonfinancial sectors other than the Federal Government increased their outstanding debt by 13 percent or more in each of the years 1977 through 1979. In 1980 the increase fell to 8-1/2 percent and in the first half of this year to an annual rate of 8 percent.

High interest rates have obviously created serious financial problems for many businesses and individuals. But as a result of the slow-down of growth in debt, the financing of economic activity is now on a sounder basis. The financial balance sheets of households are also improving. In May of 1979, individuals were devoting 18-1/4 percent of their after-tax incomes to repayments of instalment debt. That figure has recently declined to almost 15 percent.

More important than these signs of progress in the financial area is the evidence that inflation itself is moderating. In fact, the rise in prices has slowed more substantially this year than almost anyone had expected. During the first 8 months of 1981, consumer prices rose at a 9-1/2 percent annual rate, compared to 12 percent during the corresponding period of last year. Even more improvement is evident in prices at the producer and wholesale levels.

Some of the gain against inflation results from special factors unrelated to monetary policy. For example, the weather has been kind to us this year, and has given us bountiful harvests. Conservation of energy, in response to deregulation of oil prices and a range of other government programs, is also finally taking hold. Oil supplies are now readily available, and crude oil prices are several dollars a barrel lower than was widely forecast a year ago.

Nevertheless, progress against inflation goes beyond the effects of special factors. Prices of goods and services excluding food and energy are rising less rapidly this year than last. Troublesome sectors in which prices appeared earlier to have been particularly responsive to strong demand are showing the effects of restraint. There has been some slowing in the rise of prices for capital goods. Spot prices of industrial raw materials have actually fallen since late last year, and are now back to early 1979 levels. And house prices, whose earlier wild escalation contributed significantly to the upward spiral of consumer prices, have slowed markedly.

Can we really expect progress to continue? We can, I think, if we stick to policies of restraint. There are several reasons for optimism. First, the prospects for energy prices have been greatly improved by major alterations in the balance between supply and demand. U.S. domestic consumption of petroleum products has fallen by more than two million barrels per day since 1979; other countries have also reduced their consumption. Production of oil by non-OPEC countries, moreover, has risen substantially in recent years. Oil stocks are now so ample that OPEC no longer has the latitude for increases in oil prices well above the general inflation rate.

The Administration, with the assistance of the Congress, has taken a number of important steps that will contribute to curbing inflation. The depreciation and investment tax credit provisions of the Economic Recovery Act of 1981 will help to stimulate investment and, after some time, to raise productivity. Progress is also being made in enhancing competition through regulatory reform in such industries as airlines and trucking. Strong efforts are underway to reduce the inflationary effects of government regulations -- for example, by modifying anti-pollution regulations and reforming the administration of the Davis-Bacon and Service-Contract Acts, which raise costs in the construction and service industries.

Progress against inflation will continue, however, only if we succeed in reducing the rise in unit costs of production -- particularly labor costs, which amount to roughly two-thirds of the total. For the past several years, wage increases have exceeded the very sluggish rise of productivity by 8 to 9 percentage points a year. There is little reason to be very hopeful that our economy will break out of its productivity doldrums at any time soon. But we <u>can</u> make headway against rising costs by reducing wage increases, and that process has gotten underway. Average hourly earnings of production and supervisory workers in nonfarm businesses rose at an 8-1/2 percent annual rate over the first 3 quarters of this year. That is about 1 percentage point less than in the same period of 1980. Reopenings of union contracts in some industries have contributed to the moderation of wages, as well as helping to preserve jobs for workers. The list of industries in which concessions by unions have occurred is impressive, ranging from such well-known examples as autos and airlines, to less widely-publicized cases as meat packing, glass, printing and newspapers. Workers are also taking a more flexible approach toward work rules.

Next year, a new round of union contract settlements will occur in some troubled industries. Workers in such industries as trucking, construction, rubber and automobiles must surely recognize that pay increases on anything like the scale of recent years would inevitably lead to the loss of an enormous number of jobs. Wage and work-rule concessions, the recent decision by the Teamsters to begin bargaining early, and reports that a number of companies and unions are modifying national agreements to fit local situations all suggest that a new, less inflationary, pattern of wage settlement may emerge next year. If that happens, it will help to set the stage for substantial further reductions in inflation in the years to come.

We are, I believe, at a critical stage in our fight against inflation. It is within our means to consolidate our recent gains and move forward toward price stability. But let there be no mistake: either we bring the rate of inflation down further, or we will see it turn up decisively again; there is simply no middle ground.

Across our country, however, concern is growing over the economic and social costs of bringing down inflation. High interest rates are creating great structural damage to our economy, and the burdens are not being borne evenly. Thrift institutions are in deep distress; the housing industry has been devastated; auto dealers face severely depressed sales and very high costs of financing inventories; small firms in many other lines of activity are going out of business. The energy and defense industries, meanwhile, are booming, as are the high technology industries.

And so we have the anomaly of strong economic growth in the Southwest while economic conditions in the industrial heartland are perhaps at their worst in 40 years. It is not surprising, therefore, that pressures are growing for the Federal Reserve to depart from its policies of monetary restraint in an effort to bring interest rates down soon.

Such a change in the stance of monetary policy might bring temporary symptomatic relief from the pain of high interest rates, but it would surely worsen the underlying inflationary disease that is the principal cause of high interest rates. A lasting reduction of interest rates will only be accomplished if we adhere to a monetary policy that permits us to regain price stability.

The return to price stability and lower interest rates can be speeded up substantially, however, if the Congress and the Administration work together to eliminate the prospects for alarmingly large Federal deficits in the years just ahead. The Economic Recovery Act of 1981 provided reductions in taxes on an unprecedented scale; the Congress also reduced Federal expenditures, but by nowhere near as much as the reduction in taxes. Consequently, we face the prospect of continued large, and perhaps even growing, Federal deficits in the years to come.

For example, the Congressional Budget Office has estimated that the Federal deficit would continue to be at least $50 billion through fiscal 1984, even if federal outlays in that year were reduced by $50 billion more than the savings thus far enacted into law. Furthermore, the CBO's estimates of the deficit are premised on relatively optimistic projections of real growth in the economy. If those additional $50 billion in expenditure reductions were not achieved, and if economic growth were less robust than the CBO projected, the Federal deficit in fiscal 1984 could reach or even exceed $100 billion. Small wonder, then, that participants in financial markets are deeply worried. They know that unless the Congress and the Administration address this problem forthrightly, we may face intolerably high interest rates for the foreseeable future.

Our long-run battle to invigorate the economy by ridding it of inflation would be enhanced, I believe, if a substantial part of the steps to reduce these large prospective deficits came from further cutbacks in Federal outlays. That may or may not prove feasible. If not, some of the loss in Federal revenues that resulted from this year's tax law will simply have to be restored.

I would hope that the Congress and the Administration would act promptly, so that fiscal and monetary policy will be working together to bring down inflation. Interest rates would then come down sooner, and the burdens of fighting inflation would be spread more evenly. Rest assured, however, that the Federal Reserve will stay with its policies of monetary restraint for as long as is necessary to win the battle against inflation. We have come a long way, and we certainly have no intention of turning back now.

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