

For release on delivery  
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Remarks of  
  
Frederick H. Schultz  
  
Vice Chairman  
  
Board of Governors of the Federal Reserve System  
  
before the  
  
Commonwealth Club of California  
  
San Francisco, California

August 15, 1980

AS I REFLECT UPON THE CURRENT ECONOMIC DOWNTURN, I'M REMINDED OF A DENNIS THE MENACE CARTOON I ONCE SAW IN WHICH DENNIS EMERGES FROM A MUD PUDDLE, WITH MUD UP TO HIS NOSE, COMMENTING "UNTIL YOU REACH THE BOTTOM, IT'S DIFFICULT TO KNOW HOW DEEP A MUD PUDDLE REALLY IS." SIMILARLY WITH RECESSIONS. CLEARLY, ECONOMIC ACTIVITY HAS BEEN FALLING SHARPLY SINCE EARLY THIS YEAR. THE DROP THIS SPRING IN THE NATION'S GROSS NATIONAL PRODUCT, ADJUSTED FOR INFLATION, WAS ONE OF THE MOST SEVERE IN THE POST-WAR PERIOD. SUCH AN ABRUPT FALL OFF OF ACTIVITY SO EARLY IN A RECESSION RAISES DENNIS THE MENACE TYPE QUESTIONS ABOUT HOW DEEP THIS RECESSION IS LIKELY TO BE AND WHEN ARE WE LIKELY TO TOUCH BOTTOM. ALTHOUGH FORECASTING THE COURSE OF THE ECONOMY IS ALWAYS FILLED WITH UNCERTAINTIES, IT APPEARS TO ME THAT THE END OF THE RECESSION MAY SOON BE IN SIGHT.

BUT WHATEVER THE NEAR-TERM COURSE OF THE ECONOMY, WE MUST NOT LET OUR ATTENTION BE DISTRACTED FROM THE MAJOR LONG-TERM PROBLEM OF INFLATION. RISING INFLATION OVER THE LAST 15 YEARS HAS CREATED OUR DIFFICULTIES. INFLATION CAUSED THIS RECESSION, INFLATION WILL SLOW THE RECOVERY, AND UNLESS WE GET IT UNDER CONTROL INFLATION WILL GENERATE A FINANCIAL COLLAPSE WHICH CANNOT HELP BUT RESULT IN MAJOR CHANGES IN OUR ECONOMIC AND POLITICAL SYSTEMS.

### 1975-1979: GROWING STRAINS

THIS DIFFICULT SITUATION OF RECESSION AND INFLATION HAD ITS GENESIS IN THE VIETNAM WAR BUT A LOOK AT THE FUNDAMENTAL FORCES AT WORK IN THE ECONOMY THESE PAST FEW YEARS CAN IMPROVE OUR UNDERSTANDING OF WHY THE PROBLEM HAS REACHED SUCH MAJOR PROPORTIONS. FROM 1975 TO 1979 THE ECONOMY WAS GATHERING STEAM. THE UPTURN, THE NATION'S LONGEST PEACETIME EXPANSION SINCE 1945, BROUGHT WITH IT IMPRESSIVE GAINS IN EMPLOYMENT AND INCOMES. HOWEVER, IN 1979, INCREASING UTILIZATION RATES OF CAPITAL AND LABOR RESOURCES WERE BEGINNING TO PUT SERIOUS UPWARD PRESSURES ON PRICES. AT THE SAME TIME, GROWTH OF PRODUCTIVITY--AN OFFSET TO RISING INFLATIONARY PRESSURES--WAS NONEXISTENT. INTO THIS INFLATIONARY SITUATION WAS ADDED THE MASSIVE 150 PERCENT INCREASE IN THE PRICE OF IMPORTED OIL. IN COMBINATION WITH THE ALREADY EXISTING DOMESTIC PRESSURES ON RESOURCES, THE OIL PRICE RISE TRIGGERED AN INFLATIONARY SPIRAL.

### INFLATION-INDUCED EXCESSES

WITH PRICES ACCELERATING, A SPECULATIVE FEVER BEGAN TO DEVELOP AS CONSUMERS AND BUSINESS SOUGHT WAYS OF HEDGING

AGAINST INFLATION. FUNDS AND EFFORTS THAT NORMALLY WOULD BE FUNNELLED INTO PRODUCTIVE USES WERE CHANNELLED INTO NONPRODUCTIVE USES. SPECULATIVE EXCESSES LED TO NEAR STAMPEDES TO BUY GOLD AND OTHER PRECIOUS METALS. AT THE SAME TIME, NEW AND EXISTING HOUSES AND CONDOMINIUMS WERE SNATCHED UP AS SOON AS THEY HIT THE MARKET AS PEOPLE TRIED TO SPECULATE ON THE RISE IN HOME PRICES. INSTEAD OF SAVING, HOUSEHOLDS WENT ON A BORROWING SPREE. CONSUMERS TOOK ON A RECORD AMOUNT OF NEW DEBT LAST YEAR AND THE SHARE OF INCOME NEEDED TO SERVICE OUTSTANDING DEBT ALSO REACHED A RECORD HIGH LEVEL. THE PREVAILING ATTITUDE SEEMED TO BE, "BUY NOW, AND ON CREDIT, FOR TOMORROW THE CAR, HOUSE, AND STEREO WILL COST MORE, MUCH MORE." SUCH AN ATTITUDE, OF COURSE, TENDS TO BE SELF-FULFILLING. AND AN EXPANSION, BASED ON INFLATIONARY PSYCHOLOGY AND ON SPECULATION IS A VERY UNHEALTHY AND UNSTABLE ONE.

### POLICY RESPONSE

TO PREVENT A SEVERE COLLAPSE OF THE ECONOMY UNDER THE STRAINS OF THESE INFLATION-INDUCED EXCESSES, MONETARY

AND FISCAL POLICIES WERE INSTITUTED TO RESTORE PRICE STABILITY AND TO CORRECT THE WORSENING IMBALANCES IN THE ECONOMY. THE FEDERAL RESERVE BOARD'S STRATEGY FOR ACHIEVING THESE OBJECTIVES HAS BEEN TO RESTRAIN THE SUPPLY OF MONEY AND CREDIT. AT THE FEDERAL GOVERNMENT LEVEL, THE EFFORT WAS TO CURB GOVERNMENT EXPENDITURES.

### NATURE OF THE RECESSION

IN THE MEANTIME, THE CORROSIVE EFFECTS OF INFLATION ON INCOMES AND ON OUTPUT RESULTED IN A DOWNTURN IN ECONOMIC ACTIVITY. ALTHOUGH THE EFFECTS OF THE RECESSION CAN BE SEEN IN MOST SECTORS, THE SHARPEST DECLINES GENERALLY HAVE BEEN IN SALES OF CONSUMER DURABLE GOODS, ESPECIALLY AUTOMOBILES, AND IN HOUSING-RELATED INDUSTRIES--SECTORS WHERE THE STRENGTH LAST YEAR WAS BASED ON BORROWING. AREAS OF THE COUNTRY WITH HEAVY CONCENTRATIONS OF SUCH INDUSTRIES HAVE BEEN MOST SEVERELY AFFECTED BY THE DOWNTURN. MICHIGAN, FOR EXAMPLE, WITH ITS RELIANCE ON THE AUTOMOBILE INDUSTRY, IS AMONG THE HARDEST HIT. UNEMPLOYMENT IN MICHIGAN HAS ABOUT DOUBLED IN THE PAST YEAR AND THE UNEMPLOYMENT RATE IN JULY WAS NEARLY 14 PERCENT. IN CONTRAST, CALIFORNIA, WITH ITS DIVERSE ECONOMIC RESOURCE BASE, HAS HAD A CONSIDERABLY SMALLER RISE IN UNEMPLOYMENT DURING

THE PAST YEAR; THE JULY UNEMPLOYMENT RATE WAS UNDER 7 PERCENT, ABOUT HALF THAT OF MICHIGAN. HOWEVER, EVEN IN THIS RELATIVELY PROSPEROUS STATE, THE HOUSING SECTOR HAS UNDERGONE A SHARP RETRENCHMENT WITH HOUSING STARTS OFF ABOUT 50 PERCENT IN THE PAST YEAR.

### INDICATIONS OF A NEAR-TERM TROUGH

ENCOURAGINGLY, THE MOST RECENT DATA FOR A WIDE VARIETY OF ECONOMIC INDICATORS SUGGEST THAT WE MAY BE APPROACHING THE BOTTOM OF THIS RECESSION. IT APPEARS THAT THE ADJUSTMENTS THAT NORMALLY OCCUR THROUGHOUT A RECESSION, AND WHICH BRING ABOUT A RECOVERY, ARE BEING COMPRESSED INTO THE EARLY STAGE OF THIS RECESSION. WE HAVE ALREADY SEEN A SHARP, IN FACT A RECORD, FALL IN INTEREST RATES, BRINGING ABOUT AN UPTURN IN THE HOUSING MARKET. THE NUMBER OF NEW HOUSES STARTED IN JUNE INCREASED BY NEARLY A THIRD, AND PERMITS FOR NEW RESIDENTIAL CONSTRUCTION ROSE BY A SIMILAR AMOUNT. QUALITATIVE REPORTS FROM AROUND THE COUNTRY ALSO SUPPORT THE VIEW THAT AN UPTURN IN THE HOUSING MARKET IS ALREADY UNDERWAY.

IN THE HOUSEHOLD SECTOR, THERE HAS BEEN A SHARP CURTAILMENT OF BORROWING AND A REDUCTION IN THE SHARE OF INCOME NEEDED TO PAY OFF EXISTING DEBT. SUCH AN ADJUSTMENT LAYS THE FOUNDATION FOR A HEALTHY RECOVERY OF CONSUMER SPENDING. ALSO, SURVEYS OF CONSUMER CONFIDENCE SHOW AN IMPROVEMENT IN CONSUMER'S ATTITUDES. THE MOST RECENT DATA ON CONSUMER SPENDING SUPPORT

THIS VIEW THAT THE DECLINES IN CONSUMER SPENDING ARE MODERATING. TOTAL PERSONAL CONSUMPTION EXPENDITURES IN REAL TERMS IN JUNE LEVELLED OFF AFTER FOUR CONSECUTIVE MONTHLY DECLINES. AND MORE RECENTLY, AUTOMOBILE SALES IN JULY PICKED UP NOTICEABLY.

AN IMPROVEMENT IN CONSUMER SPENDING AND HOUSING DOES NOT MEAN THAT THE RECESSION HAS ENDED. HOWEVER, CONSUMER EXPENDITURES AND RESIDENTIAL CONSTRUCTION ACCOUNT FOR TWO-THIRDS OF TOTAL SPENDING IN THE ECONOMY AND AN UPTURN IN THESE AREAS, OR EVEN JUST AN END TO THE DECLINES, WOULD SUGGEST THAT THE RECESSION MAY BE APPROACHING ITS END.

ON THE OTHER HAND, THE BOTTOMING PROCESS DOES NOT OCCUR SIMULTANEOUSLY IN ALL SECTORS. BUSINESSMEN HAVE REACTED VERY QUICKLY AND PRODUCTION HAS BEEN CUT BACK IN RESPONSE TO SHRINKING SALES. BUT THE INVENTORY SALES RATIO IS STILL HIGH, AND FURTHER INVENTORY ADJUSTMENT IS LIKELY. BUSINESS SPENDING ON PLANT AND EQUIPMENT TENDS TO LAG IN THE CYCLE. IN THIS SECTOR MOST OF THE DROP IS LIKELY AHEAD OF US. SO ALTHOUGH SOME INDUSTRIES ARE MOVING UP AND OTHERS ARE BEGINNING TO HIT BOTTOM, ANY OVERALL RECOVERY IS 'STILL SOME MONTHS IN THE FUTURE.

### SLUGGISH RECOVERY

WHEN THE RECOVERY DOES BEGIN, IT IS LIKELY TO BE QUITE SLUGGISH BECAUSE INFLATION AND INFLATIONARY EXPECTATIONS WILL STILL BE MUCH TOO HIGH. IT IS TRUE THAT THE SLACK UTILIZATION

OF RESOURCES ASSOCIATED WITH RECESSIONS TENDS TO REDUCE INFLATION, AND THIS PRESENT DOWNTURN SHOULD BE NO EXCEPTION. HOWEVER, SINCE THE EARLY 1960s, EACH RECESSION HAS HAD LESS OF AN EFFECT ON REDUCING INFLATION THAN THE PREVIOUS EXPANSION HAD ON INCREASING IT. OVER THE NEXT FEW MONTHS THE CONSUMER PRICE INDEX WILL LOOK MUCH BETTER, PROBABLY DROPPING TO SINGLE DIGIT LEVELS. BUT WE MUST NOT BE FOOLED. THE UNDERLYING RATE OF WAGE AND PRICE INFLATION REMAINS HIGH. AS A MATTER OF FACT, HOURLY COMPENSATION IN THE SECOND QUARTER INCREASED EVEN FASTER THAN BEFORE THE RECESSION BEGAN.

INFLATION AND A SOUND RECOVERY ARE NOT COMPATIBLE. INFLATION, AS WE HAVE SEEN, PENALIZES SAVING, PROMOTES NON-PRODUCTIVE ACTIVITIES AND SPECULATION, AND PREVENTS CONFIDENT BUSINESS AND HOUSEHOLD PLANNING. EXPECTATIONS OF HIGHER PRICES ALSO PUSH UP INTEREST RATES SINCE LENDERS DEMAND RATES OF RETURN AT LEAST SUFFICIENT TO COVER THEIR LOSSES DUE TO INFLATION. HIGHER INTEREST RATES, IN TURN, CAN CURTAIL HOUSING ACTIVITY, BUSINESS INVESTMENT, AND CONSUMER SPENDING.

#### MONETARY POLICY MUST FIGHT INFLATION

IT IS FOR THESE REASONS THAT DEALING WITH INFLATION HAS BEEN, AND MUST REMAIN, THE FIRST PRIORITY OF ECONOMIC POLICY. MONETARY POLICY, AND, THEREFORE, THE FEDERAL RESERVE BOARD, HAS A CRUCIAL ROLE TO PLAY IN THIS EFFORT TO RESTORE



PRICE STABILITY. HISTORY DEMONSTRATES THAT INFLATION IS NURTURED BY EXCESSIVE GROWTH OF MONEY AND CREDIT--ESPECIALLY IN THE EARLY STAGES OF A RECOVERY--AND THAT THE PROCESS OF UNWINDING AN INFLATIONARY SPIRAL REQUIRES MONETARY DISCIPLINE. THE FEDERAL RESERVE IS COMMITTED TO SUCH DISCIPLINE. SINCE LAST OCTOBER, WE HAVE PLACED MUCH GREATER EMPHASIS ON THE IMPORTANCE OF LIMITING THE GROWTH OF THE MONEY STOCK. THIS IMPLIES THAT INTEREST RATES MIGHT MOVE OVER A WIDER RANGE THAN PREVIOUSLY, REFLECTING CHANGES IN THE DEMAND FOR MONEY AND CREDIT. SUCH A LARGE SWING OCCURRED THIS SPRING WHEN INTEREST RATES REACHED RECORD HEIGHTS AND THEN FELL BACK FASTER THAN EVER BEFORE. THE RECENT DECLINE IN INTEREST RATES HAS BEEN INTERPRETED BY SOME AS AN EASING OF FEDERAL RESERVE POLICY. LET ME EMPHASIZE THAT THIS IS NOT THE CASE--JUST AS THE EARLIER RISE DID NOT REPRESENT A TIGHTENING OF POLICY. RATHER, MONETARY POLICY THROUGHOUT THIS YEAR HAS MAINTAINED A STEADY ANTI-INFLATIONARY COURSE BASED UPON A SET OF TARGETS FOR THE MONETARY AGGREGATES THAT ARE WIDELY ACCEPTED AS APPROPRIATE AND CONSISTENT WITH REDUCING INFLATIONARY PRESSURES OVER TIME.

FOR NEXT YEAR, THE FEDERAL RESERVE HAS ANNOUNCED TARGET RANGES FOR THE MONETARY AGGREGATES THAT ARE GENERALLY 1/2 PERCENTAGE POINT LOWER THAN FOR 1980. WITH INFLATION RATES

LIKELY TO REMAIN HIGH NEXT YEAR AND WITH ECONOMIC ACTIVITY PICKING UP, PRIVATE DEMANDS FOR CREDIT WILL ACCELERATE. IF GOVERNMENT CREDIT DEMANDS REMAIN HIGH, INTEREST RATES COULD COME UNDER INCREASING PRESSURE. A DISCIPLINED MONETARY POLICY EARLY IN AN EXPANSION RUNS SOME RISK OF LIMITING THE RECOVERY. TYPICALLY, THE FEDERAL RESERVE HAS ACCOMMODATED THE RENEWED DEMANDS FOR MONEY AND CREDIT AT THE EARLY STAGE OF AN UPSWING--A TIME WHEN THERE IS EXTENSIVE UNDERUTILIZATION OF CAPITAL AND LABOR RESOURCES. TO ABANDON OUR POLICY OF RESTRAINED MONETARY GROWTH, HOWEVER, WOULD BE A MISTAKE. IT IS ESSENTIAL THAT WE STICK TO A FIRM POLICY OF SLOWLY LOWERING THE GROWTH OF MONEY TO NONINFLATIONARY LEVELS. ONLY IN THAT WAY WILL WE BE ABLE TO BREAK THE EXPECTATIONS THAT INFLATION WILL CONTINUE TO ACCELERATE.

#### NEED COORDINATED PROGRAM TO ATTACK INFLATION

MONETARY POLICY ALONE CANNOT SUCCEED IN UNDOING THE INFLATIONARY PROCESS. THE EXPECTATIONS OF INFLATION ARE TOO DEEPLY ROOTED IN OUR ATTITUDES AND INSTITUTIONS TO BE REVERSED BY A SINGLE POLICY INSTRUMENT OR TO BE UNWOUND IN A SHORT PERIOD OF TIME. WE NEED A COORDINATED PROGRAM TO FIGHT INFLATION AND ONE THAT IS MAINTAINED FOR A LONG TIME. SUCH A PROGRAM NEEDS TO ATTACK INFLATION FROM AT LEAST THREE DIFFERENT ANGLES--NAMELY, REDUCE OUR DEPENDENCE ON FOREIGN OIL; IMPROVE OUR PRODUCTIVITY PERFORMANCE; AND CONTINUE TO DIRECT OUR GOVERNMENT POLICIES TO CURBING INFLATION.

## I. REDUCE DEPENDENCE ON FOREIGN OIL

FIRST, THE OPEC SITUATION. SEVEN YEARS AFTER THE INITIAL MASSIVE OPEC PRICE RISE, WE ARE STILL EXTREMELY VULNERABLE TO THE PRICING DECISIONS OF THAT CARTEL. IN 1973, 40 PERCENT OF OUR TOTAL OIL CONSUMPTION CAME FROM ABROAD; BY 1979 THIS WAS APPROACHING 50 PERCENT. IN 1973, THE UNITED STATES PAID ABOUT \$8-1/2 BILLION FOR IMPORTED OIL. THIS YEAR THE BILL FOR IMPORTED OIL WILL BE NEARLY \$90 BILLION. WE ARE ABOUT 5 PERCENT OF THE WORLD'S POPULATION, BUT WE CONSUME A THIRD OF ITS OIL PRODUCTION. ALTHOUGH PROGRESS HAS BEEN MADE IN RECENT YEARS IN CONSERVING ENERGY, IT IS CLEAR THAT WE STILL NEED TO MAKE CONSIDERABLY GREATER EFFORTS IN CONVERTING TO MORE ENERGY-EFFICIENT SYSTEMS. AT THE SAME TIME, WE NEED TO DEVELOP FURTHER OUR INDIGENOUS ENERGY SOURCES. THE SYNTHETIC FUEL PROJECTS IN THE PRESIDENT'S ENERGY PROGRAM ARE EXAMPLES OF THE KIND OF INNOVATIVE MEASURES WE NEED TO BOOST OUR OWN ENERGY PRODUCTION. SIMILARLY, THE PROGRESSIVE DECONTROL OF DOMESTIC OIL PRICES SHOULD HELP BOOST PRODUCTION BY STIMULATING DRILLING AND ENCOURAGING NEW TECHNIQUES TO INCREASE RECOVERY.

## 2. IMPROVE PRODUCTIVITY

THE SECOND APPROACH FOR ATTAINING PRICE STABILITY IS TO IMPROVE OUR PRODUCTIVITY PERFORMANCE. GAINS IN PRODUCTIVITY, THAT IS, IN THE OUTPUT PRODUCED PER HOUR BY OUR WORKFORCE,

HAVE BEEN ON A DECLINING TREND OVER THE POST-WAR PERIOD. DURING THE FIRST 15 YEARS AFTER THE WAR, PRODUCTIVITY ROSE ABOUT  $3\frac{1}{4}$  PERCENT ON AVERAGE PER YEAR. IN THE NEXT DECADE, PRODUCTIVITY GAINS AVERAGED ONLY  $2\frac{3}{4}$  PERCENT; AND FROM 1973 ON, PRODUCTIVITY ROSE ONLY  $1\frac{1}{2}$  PERCENT PER YEAR. THE LESS PRODUCTIVITY GROWTH THERE IS, THE MORE DIFFICULT WILL BE THE TASK OF CONTAINING INFLATION AND THE SLOWER WILL BE THE ADVANCE IN OUR STANDARD OF LIVING.

THERE IS NO SIMPLE, SINGLE EXPLANATION FOR THE SLOW-DOWN IN PRODUCTIVITY. BUT ONE OF THE CAUSES APPEARS TO HAVE BEEN INADEQUATE BUSINESS CAPITAL FORMATION--THAT IS, THE BUILDING OF NEW PLANT AND EQUIPMENT. DURING THE PERIOD FROM 1948 TO 1973, THE NET ADDITIONS TO THE NATION'S PRIVATE CAPITAL STOCK WERE AT ABOUT A  $4\frac{1}{2}$  PERCENT ANNUAL RATE. SINCE THEN, HOWEVER, ADDITIONS TO THE CAPITAL STOCK HAVE SLOWED TO ABOUT A  $2\frac{3}{4}$  PERCENT RATE. MEANWHILE, GROWTH OF THE LABOR FORCE HAS ACCELERATED. AS A RESULT, THERE HAS BEEN VERY LITTLE INCREASE IN RECENT YEARS IN THE AMOUNT OF CAPITAL AVAILABLE ON AVERAGE TO EACH WORKER.

MOREOVER, COMPARED TO OUR TRADING PARTNERS, WE ARE DEVOTING LESS OF OUR RESOURCES TO CAPITAL FORMATION. BUSINESS INVESTMENT AS A SHARE OF OUTPUT IS ONLY ABOUT 10 PERCENT IN THE UNITED STATES, ABOUT HALF THE SHARE DEVOTED TO INVESTMENT

IN JAPAN, FOR EXAMPLE. UNLESS WE INCREASE OUR INVESTMENT SHARE, WE WILL BE A SECOND-CLASS INDUSTRIAL NATION PLAGUED BY HIGH INFLATION AND SLOW GROWTH.

THE SLOWDOWN IN CAPITAL FORMATION OVER THE LAST HALF OF THE 1970s IS DUE TO SOME EXTENT TO THE TAX CODE, WHICH IS BIASED AGAINST THE SAVINGS AND INVESTMENT PROCESS. UNFORTUNATELY, THERE IS NO SURE-FIRE WAY TO AUGMENT SAVING AND INVESTMENT AND TO RESTORE PRODUCTIVITY GROWTH. BUT A MOST PROMISING APPROACH IS TO MODIFY THE TAX SYSTEM TO ENCOURAGE, RATHER THAN TO INHIBIT, SAVING AND INVESTMENT.

### 3. GOVERNMENT POLICIES

THIS LEADS DIRECTLY TO THE FINAL ASPECT OF A COORDINATED PROGRAM DESIGNED TO CURB INFLATION, NAMELY GOVERNMENT POLICY. THERE IS A LOT OF TALK THESE DAYS ABOUT THE WISDOM AND TIMING OF ANY POSSIBLE TAX CUT. IN THE LONG RUN, IT IS A GOOD IDEA TO CUT TAXES AND RESTORE SPENDING POWER TO THE PRIVATE SECTOR. AT THIS CRUCIAL JUNCTURE IN THE FIGHT FOR CONTROL OF INFLATION, HOWEVER, A TAX CUT RISKS AGGRAVATING INFLATIONARY EXPECTATIONS. IT WOULD BE A GREAT TRAGEDY IF CONGRESS RUSHED THROUGH A TAX-CUTTING BILL WITHOUT CAREFULLY STUDYING ITS INFLATIONARY RAMIFICATIONS. AN ILL-CONCEIVED TAX PACKAGE, ONE BASED ON POLITICAL EXPEDIENCIES, COULD EASILY AND ALL TOO QUICKLY UNDO ANY GAINS BEING MADE ON THE INFLATION FRONT. IF A TAX CUT

EVENTUALLY SHOULD PROVE NEEDED, IT IS IMPERATIVE THAT IT BE CAREFULLY STRUCTURED SO AS TO BOOST INVESTMENT RATHER THAN INCREASE CONSUMER SPENDING. A TAX CUT THAT IMPROVES THE PRODUCTIVE POTENTIAL OF THE ECONOMY COULD AID THE FIGHT AGAINST INFLATION WHILE ONE THAT JUST RAISES HOUSEHOLDS' AFTER-TAX INCOME MIGHT REIGNITE THE INFLATIONARY SPIRAL.

ANOTHER ELEMENT IN A FEDERAL GOVERNMENT ANTI-INFLATION PROGRAM WOULD BE TO REDUCE THE REGULATORY BURDEN ON THE PRIVATE SECTOR. WE NEED TO COMPARE THE COSTS OF COMPLYING WITH GOVERNMENT REGULATIONS WITH THE BENEFITS REAPED. OBSOLETE REGULATIONS RAISE COSTS OF PRODUCTION, INHIBIT EFFICIENCY, AND, THEREBY, CONTRIBUTE TO INFLATION. EVEN WHEN SOME REGULATIONS ARE NEEDED, FOR EXAMPLE, IN THE FIELDS OF HEALTH, SAFETY, AND ENVIRONMENT, WE MUST SEEK THE LEAST COSTLY MEANS TO ACHIEVE A GIVEN AIM. IN RECENT YEARS, THERE HAS BEEN AN INCREASING AWARENESS OF THE COSTS OF REGULATION, AND MEASURES HAVE BEEN TAKEN TO EASE THE REGULATORY BURDEN. BUT MORE CAN AND MUST BE DONE IN THIS AREA.

#### SUMMARY OF PRIORITIES AND PROGRAM

IT IS FAR FROM EASY TO DECIDE UPON THE APPROPRIATE POLICY PRESCRIPTION AT A TIME OF BOTH SERIOUS RECESSION AND RAPID GROWTH OF PRICES. HOWEVER, IT APPEARS TO ME THAT GIVEN

THE GROWING SIGNS THAT THE RECESSION WILL SOON BE COMING TO AN END, WE MUST PLACE THE HIGHEST PRIORITY ON CURBING INFLATION AND MAINTAIN THAT PRIORITY EVEN DURING THE RECOVERY. WE NEED TO PURSUE A MULTI-FACETED PROGRAM DESIGNED TO REDUCE OUR DEPENDENCE ON FOREIGN OIL, INCREASE OUR BUSINESS INVESTMENT, AND IMPROVE OUR PRODUCTIVITY. AT THE FEDERAL GOVERNMENT LEVEL, WE NEED TO MODIFY OUR TAX STRUCTURE TO PROVIDE INCENTIVES TO ACHIEVE THESE GOALS. WE NEED TO CURB GOVERNMENT SPENDING AND EASE THE REGULATORY BURDEN. AT THE SAME TIME, THE FEDERAL RESERVE MUST--AND I CAN ASSURE YOU IT WILL--MAINTAIN A STEADY ANTI-INFLATIONARY COURSE FOR MONETARY POLICY.

UNWINDING OF INFLATION EXPECTATIONS LIKELY OVER TIME

WILL SUCH A PROGRAM WORK? I AM CONFIDENT THAT IT WILL. NOT BY TOMORROW, NOT BY NEXT YEAR, BUT OVER TIME, A CONSISTENT, FIRM ANTI-INFLATIONARY POLICY WILL BREAK THE BACK OF INFLATIONARY EXPECTATIONS. JUST AS EXPECTATIONS OF HIGHER INFLATION BECOME SELF-FULFILLING, SO, TOO, CAN EXPECTATIONS THAT INFLATION IS WINDING DOWN.

BY MAINTAINING A FIRM MONETARY POLICY DURING THE UPSWING--EVEN THOUGH THIS MAY MEAN A SLOWER RECOVERY--WE CAN MAKE CONSIDERABLE INROADS INTO LOWERING THE RATE

OF INFLATION. A LOWER RATE OF INFLATION WILL FEED IN TURN INTO LOWER RATES OF WAGES, AND BACK AGAIN INTO LOWER PRICES. AS PROGRESS IS MADE, MORE AND MORE HOUSEHOLDS AND BUSINESSES WILL BEGIN TO ACT ON THE ASSUMPTION OF A SLOWER GROWTH OF PRICES AND WAGES IN THE YEARS AHEAD, RATHER THAN THE ASSUMPTION OF ACCELERATING INFLATION. AS THIS UNWINDING OF INFLATIONARY EXPECTATIONS TAKES HOLD, WE WILL PROBABLY SEE A FASTER DOWNWARD ADJUSTMENT OF ACTUAL INFLATION RATES THAN MANY OBSERVERS ARE CURRENTLY PREDICTING.

WE ARE NOW AT A CRITICAL POINT IN OUR ATTACK ON INFLATION, A POINT WHERE SOME PEOPLE ARE URGING A CHANGE IN PRIORITIES AND AN EASING UP IN ANTI-INFLATIONARY POLICIES. TO DO SO NOW WOULD BE FOOLISH, FOR THE FIGHT TO RESTORE PRICE STABILITY IS ALSO THE FIGHT TO ACHIEVE STABLE LONG-TERM GROWTH OF OUTPUT, INCOME, AND EMPLOYMENT. UNLESS WE CONTROL INFLATION, WE CANNOT GENERATE THE FAITH IN THE FUTURE WHICH IS NECESSARY FOR CONSUMERS TO SAVE AND BUSINESSMEN TO INVEST. SUCH A COURSE IS NOT PAINLESS. IT REQUIRES A FIRM AND COURAGEOUS COMMITMENT TO POLICIES THAT MAY, IN THE SHORT RUN, RESULT IN SOME LOST OUTPUT AND EMPLOYMENT. HOWEVER, OVER THE LONGER TERM, SUCH POLICIES WILL NOT ONLY CREATE JOB OPPORTUNITIES BUT, MORE IMPORTANTLY, CAN RESTORE OUR COUNTRY'S BASIC STRENGTH AND SPIRIT.