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Comments by

Henry C. Wallich
Member, Board of Governors of the Federal Reserve System

at the
Concluding Meeting of the
Series "Economic Order and the Future,"
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It is a privilege to have the last word in a series of lectures in which so many distinguished speakers have preceded me. They all have, in one way or another, addressed themselves to the theme, "The Economic Order and the Future." I find the theme congenial, because in speaking about the economic order one is compelled to come face to face with fundamentals. If our present condition appears puzzling and even disturbed, it is, I believe, because we have not paid enough attention to fundamentals.

I am hopeful that the tendency to ignore fundamentals is abating. Of late we have made, to problems calling for action, responses I believe to be fundamentally right. Let me begin by sketching some of these perplexities and predicaments.

Domestically, our economy is going through a period of rising prices that is almost without precedent. At the same time, the upward growth trend of the economy was interrupted during the quarter that just ended, and unemployment rose higher than one would like to see. Scarcities of all sorts developed, some, like oil, due to the action of foreign suppliers, others, among them many relating to domestic industrial products, owing to inadequate productive capacity here at home. Internationally, the currencies of the world fluctuate against each other, sometimes by inexplicably large margins. Together with the enormous trade deficits imposed upon the oil importing countries by the exporters, this causes concern over the future of international economic relations.

Often in the past, we have met problems of this sort with improvisations that would provide "quick relief" but would hurt us in the long run. As a result, we are always living in the long-run aftermath of short-run expedients employed years ago to deal with long forgotten emergencies. In the face of our present difficulties, however, our record has been better. We have on the whole succeeded in avoiding temptations of that sort. This gives me hope that we may indeed be on our way back to the recognition of some fundamental truths. Let me exemplify.

In 1971, we went to wage and price controls because an inflation that was milder than the present one was not yielding as rapidly as we would have liked to the remedies available in a free market economy. Today, if I read the record correctly, a conviction has taken hold, with the Congress, with the Administration, with labor, and with business, that controls are a superficial remedy that may help somewhat in the short run but that in the long run does mainly damage. In all probability, the remnants of these controls will be allowed to expire on April 30. We are going back to a system in which price stability must be achieved through the balance of supply and demand in markets that should be as competitive as we can make them.

Take another example. When food and later oil and gasoline became scarce and prices skyrocketed, a public debate ensued whether rationing should be resorted to. The Congress discussed also a roll back of oil prices to deal with the consequences of the shortage. We abstained from such measures. They might have brought some short-run relief, but they surely would have been damaging to the basic fabric of our economy. Today it seems fair to assume that market forces will be allowed to work out the problems of supply in the areas of food, oil, and other materials.

Let me cite a third example. In the face of a drop in the GNP during the first quarter it might be tempting to take massive action to restimulate the economy, as has sometimes been done in the past. The result often has been that the action took effect only with a lag and hit the economy at a time when stimulation was no longer needed and restraint would have been more in order. This time, so far at least, we have managed to avoid that mistake.

As a fourth and last example, I shall turn to the international field. Wide fluctuations of exchange rates have severely tested the ability of our producers to maintain their position in international markets. Large international flows of capital have challenged our ability to conduct a monetary policy oriented exclusively toward domestic ends. In the international area, too, it would have been tempting at times to reach for controls of various sorts. Nevertheless we have abstained from the introduction of new controls. In fact, we have removed the controls over capital movements that had previously been imposed. The world has not come to an end over this, and will probably be a better place because more farsighted policies have been followed.

The actions I have cited have one common denominator. They have put the long-run health of the economy ahead of short-run pain relief. Instead of worrying about the next six months, we have done what was right for the next ten years. Instead of becoming wholly absorbed in the day-to-day performance of the economy, we have focused on conserving its underlying structure for the long pull. This has been a welcome change from our frequent tendency to focus on the urgent instead of on the important, and to give priority to short-run expediency over long-run fundamentals.

The examples I have cited, important as they are, represent isolated instances. It would not be difficult to find examples pointing in the opposite direction. For that reason, it is necessary to try to arrive at a clearer view of where we want this economy to go in the long run, what sort of economic structure we intend to have, under what kind of rules and laws we want to live. In other words, we must give thought to the nature of a durable economic order. I would like to examine with you some of the areas in which particularly important decisions are pending concerning this enduring order.

The Price Mechanism Versus Central Control

There is never a shortage of data that seem to suggest that the price mechanism is no longer working properly. Big organizations, whether business firms or labor unions, it is said, have so much power over prices and wages that the laws of competition, of supply and demand, no longer can be relied upon. Hence it is sometimes argued, with particular eloquence for instance by Ken Galbraith, that government should seek to control these powerful entities and in that way move toward a much more centrally planned economy.

Nobody can deny that big business and big labor today exert considerable power. We are not a nation of small merchants, small-scale manufacturers, and of workers dealing with their employers from a position of weakness. But we should remember that concentrations of economic power existed also in the 19th Century. The anti-competitive behavior of railroads, of the trusts, was effectively dealt with. Competition was preserved in large areas of the economy. Today, the work of the price and wage control agencies and what they have learned about the behavior of business and labor, suggests that supply and demand are far from inoperative as guides to economic action. Economic theory has discovered far more subtle responses to prices and interest rates, on the part of firms and households, than had previously been believed to exist. Improving econometric techniques, made possible by computers, have succeeded in making visible these subtle and nevertheless pervasive and powerful influences in the market. In many respects, theorists and econometricians today know more about market responses, regard them as more important, and find them applicable to wider areas, than they did in the past.

Some people view this stress on market behavior, on the effect of prices, on choices and trade-offs, with a degree of alarm. They may have an ideological commitment to enlarging the role of government, possibly because they are skeptical of a system that tolerates considerable income inequality and allows profit and private property to remain important incentives. I do not share that ideological commitment. But if I did, I would not regard reliance on markets and prices as being in conflict with such an ideology. The market system is one thing, private ownership and profit is something else. The two are related, but not identical. The defenders of the market system do indeed often argue that these institutions are inseparable, that a market system cannot survive under anything but private ownership or possibly even far-reaching laissez-faire conditions. I would not altogether ignore the reasons they adduce, but neither would I attach decisive weight to them. Historically, the market system and private ownership have gone hand in hand. I hope that we shall not find ourselves making the experiment, but in strict logic they are separable. Countries like Yugoslavia seem to be supplying evidence that a government can take advantage of the price system, of relatively free markets, and of competition, in order to improve the performance of an economy where ownership is vested in government. If one happens to believe that government is good and that more of it would be better, it is nevertheless a mistake to conclude that therefore the price system must be bad.

The Size of the Public Sector

But we need not go to theoretical abstractions, customary though this kind of approach may be in a university environment, in order to debate meaningfully the role of government. In many everyday ways, the question of the proper role of government is always with us.

It is with us in particular because of the ever pressing question of the appropriate size of the public sector.

Paul Samuelson frequently refers to our economy as a "mixed" economy, meaning that it is partly public, partly private. In fact, only about 21 per cent of the GNP is accounted for by Federal, State, and local expenditures on goods and services. The other 79 per cent are private sector expenditures. Sometimes I have wondered how Paul Samuelson would describe an economy in which those proportions were reversed -- about one-fifth private, four-fifths public. It is not plausible to me that a public sector which so far has been limited to little more than one-fifth justifies calling an economy "mixed." My doubts are not completely removed when I am reminded that the Federal Government engages in additional expenditures, such as Social Security and welfare, which transfer income from one part of the population to another and which, added to the purchases of goods and services, raise total government spending to 31.5 per cent of GNP.

Some people believe that more things should be done by Government and proportionately less through the private sector. That is one of the fundamental issues I would like to examine.

As an economist, I approach this question from the point of view of efficiency. Which sector is likely to do a better job? Many noneconomists approach the matter from a moral angle. They often are put off by the fact that private production involves profit, and some people seem to regard profit as ethically unappealing, to put it mildly. Hence, they prefer economic action through the public sector.

I do not share the moral doubts about profits, provided they were made legally and taxes were paid. The efficiency test is what I consider relevant. Profitability, of course, is a test of efficiency. When a business is profitable, there is a strong presumption that it is efficiently managed, even though there could be other reasons. The profits test, moreover, has a self-implementing feature. A business that flunks it and keeps losing money simply cannot stay in business.

Government is organized just the other way. If you run a tight ship in your department, if you keep down expenditures and have some money left over from your budget, you may be told at the next budget hearing that you had more money than you needed, and your funds may be cut. If you overspend, this may appear to demonstrate the urgent need for the services your office is providing, and your budget may be raised. Since the government administrator cannot make a profit, he may try to maximize something else -- his staff, his power, his program. I am not convinced that these incentives are conducive to maximizing the public welfare.

The same can be said of the method by which the private and the public sector respectively make their choices and decisions. The private sector allows each person to equalize costs and benefits at the margin by buying as much as he/she can afford of everything. There are no confrontations of interests, no need for political decisions, although the market system of course has its imperfections. The political process, on the other hand, leaves the individual little choice. The minority must accept what the majority decides. Few participants get exactly what they want. Continuous confrontation by public voting does not make for social harmony.

A good case, therefore, seems to me to exist for allowing as many of the economic choices that society must make to occur through the anonymous market rather than the adversary proceedings of the political process. In a modern society, to be sure, many services by their nature call for intervention of the public sector. Without a law requiring everybody to get a minimum of education, some people might never go to school. Without a law requiring people to pay for social security, part of the aged might end up destitute. Many modern social needs, moreover, call for insurance, for instance against illness and death of the family breadwinner. But it is important to note that while provision for such needs may require some kind of government compulsion, and while many of the needs, such as education and insurance, are of a collective character, the services themselves need not necessarily be provided through the public sector. The private sector might do it more efficiently, even though it may require public guidance. I would not go so far as Milton Friedman, who seems to have concluded that a government that cannot deliver the mail has little prospect of delivering anything else efficiently. But I would urge that, before we plunge for a broadening of public sector activities, we obtain a competing bid from the private sector to see which can do the job more efficiently.

Of late, some of the demands made on the public sector have run into difficulties because the technology to meet them does not seem to exist. This has been the case, for instance, with programs oriented to help disadvantaged children to read, and to train hard-core unemployed. It turns out that while the money was appropriated and the teaching and training programs were carried through, the results were not what had been expected. This is a new experience, radically different from past patterns. We have always been sure that if the government wants to do something, such as building a road, and the money is available, the road will be built and will carry traffic. But neither the government, nor possibly anybody in the private sector, knows how to make good readers out of disadvantaged children, or how to turn all hard-core unemployed into steady and efficient workers. New teaching techniques may have to be developed before public funds appropriated for these purposes can be usefully spent.

All this suggests to me that the case for not letting the public sector expand without restraint is strong. In addition, however, we must ask ourselves how much growth we want for both the private and the public sector together. Half a dozen years ago, no one would have raised that question. Continued growth, and its desirability, would have been taken for granted. Today growth has become controversial. The decision whether and how much the economy should grow has become one of the fundamental issues of our time.

How Much Growth

The attack on growth has come from two directions. There are those who claim that continued growth threatens to exhaust our resources. Reserves of minerals, metals, clean air, clean water, and even of land are being depleted, not enough food can be produced. Catastrophe is said to threaten unless this process is brought to a halt. The second line of attack has argued that, whether continued growth is possible or not, it is unworthy of human beings to concern themselves exclusively with the accumulation of more and more material things instead of devoting attention to the quality of life. Young people have responded by adopting simple life styles, and by disinteresting themselves in the functions of production and money-making. I find the second of these views more appealing than the first. Nevertheless, I suspect that both are misguided.

The shortages of food, of many raw materials, and especially of oil that we have just experienced at first sight seem to confirm the fear that we are beginning to run out of resources. In my view, however, this interpretation of recent experience is a misconception. If the markets are allowed to do their job, they will meet the situation by producing more of the needed goods, by developing substitutes, and by cutting down the demand. Higher prices for many commodities may, of course, prove unavoidable. That is part of the process. We will have shortages if we interfere with the pricing system, by imposing ceilings, or by interfering with supplies. The rise in oil prices constitutes, of course, an interference with supply on the part of the oil-exporting countries, undertaken for the purpose of raising the price. Other supply difficulties have occurred because, usually with a good motive but not always with good sense, we have sought to protect the environment without properly calculating the time it would take for productive processes to adjust. We shall pay a price for all this, in a temporary slowdown of growth and in a lot of turmoil throughout our markets. But I do not believe that anything has happened to reduce permanently the prospect for economic growth, so far as the economist's eye can see.

The view that our society is too materialistic, and that man was made for better things than what can be sold by advertising, I share. I have little doubt that there are many people like myself who would be quite willing to stabilize their standard of living instead of working desperately to double it in each generation. Unfortunately, the willingness to stabilize living standards is not widely shared, with the exception of what I fear to have been a rather passing phase in the attitudes of young upper middle class people. And the great majority who want to improve their lot are perfectly right so long as incomes throughout the world are very unequal, and so long as the great majority is exposed to the demonstration effect of the living standards of the minority that are far above their own. This is true within each nation, whether it be the United States or India. Within each country the lower income groups feel that they have a long distance to go before they have enough. The same is true also between countries, as the developing countries observe the wealth of the developed and want to reach the same levels.

I must confess that I can see no solution to this problem, although time undoubtedly will supply one. Massive redistribution is not the answer. The upper income brackets in any country, even though they may be willing to forego the prospects of getting still more, certainly are not disposed to accept substantially less than they have. You need only consider the enormous reduction in the income levels of millions of Americans that would be required in order to bring all incomes to the neighborhood of the national average. The same is true when you consider the amounts that the United States would have to distribute to the developing countries if per capita income all over the world were to be equalized. Nothing like that is conceivable, nor in all probability would it be desirable. As Kenneth Boulding said in one of the earlier lectures in this series, there can be too much of everything, even of equality.

Economic growth, therefore, will probably continue in the foreseeable future. Short-term limitations can be overcome. Most people as yet are not minded to be content with what they have. If that prediction is correct, it will be incumbent upon us to make sure that the demand for "more" can be satisfied smoothly and without damaging repercussions for the economy and for the environment. To do this, we must meet certain prerequisites. We must deal intelligently with the natural resource problem. The price system, as I said before, will do the job in most cases if it is not interfered with too seriously. Some of the resulting price movements may create burdens. They may also create large profits. If we make it our principal objective to avoid all burdens, and to prevent anybody from profiting from the situation, we shall be blocking the machinery that alone can provide what is needed. The impulses that might drive us to such actions are understandable and humane. They are nonetheless counter-productive.

In addition to the need to let the price system generate resources, or economize their use, or provide substitutes, we shall need capital equipment to generate larger output. If this is to be done in ways that economize natural resources and protect the environment, the need for equipment will be even larger. Our present experience shows that we are substantially underequipped. Many industries have been suffering from capacity shortages, which have been one of the reasons for rising prices.

Past investment in capacity has been inadequate. For instance, there has been no increase at all in the amounts invested annually in the manufacturing industries, after making allowance for higher equipment prices and for types of investment that serves to protect the environment rather than to increase output. Owing to the high rate of inflation, the depreciation allowances charged by business for the purpose of replacing worn out equipment have become inadequate. We are now significantly underdepreciating our plant and equipment. Our financial resources for expanding the capital stock are becoming further inadequate because the profits that business believes itself to be retaining have been seriously overstated by the distortions of inflation.

If we want a high rate of investment, we need policies that encourage saving on the part of households and business. We need policies also that encourage investment of these savings. The United

States, at the household level, has never been a high saving economy. Household savings have fluctuated, most of the time, in the range of 5-8 per cent of disposable income. This contrasts with savings rates of 12 per cent in Germany and 20 per cent in Japan. Gross investment in the U.S., including corporations and government, has been of the order of 17 per cent of GNP, compared with something like 25 per cent in Germany and as much as 40 per cent in Japan. The need to provide substitute sources of energy and to protect the environment will call for larger investment.

But in addition to increased material resources, we need the right kind of social attitudes. We need an attitude that regards production to meet human needs as a worthwhile activity rather than as outmoded drudgery. To contribute to the vast processes of production is no unworthy endeavor. No one who decides to devote his life to the tasks of business need be ashamed of that decision or to think less well of himself than if he/she were planning to become a teacher, government administrator, or scientist. Everybody should feel free to do what he wants to do, but in the end we should remember that we must all help to produce GNP.

Inflation

I have argued that a return to fundamental values is necessary in the areas of the price system, the size of the public sector, and the level of productive investment. In all of these areas, we have experienced some softening of attitudes, and we are today suffering the consequences. Nothing so clearly shows the cost of temporizing and compromising, of putting the short-run ahead of the long, of reaching for expedients rather than solutions, as does the inflation from which we are suffering. Prices are now rising at rates which in the past were observed mainly in some Latin American countries. The incomes of the unorganized and of the retired are eroded, savings accumulated over a lifetime lose their value, and people no longer know how they can protect their future.

We have reached these high rates of inflation because, in successive business cycles, we have never had the will to put an end to rising prices. Thus, predictably, each time round things have gotten worse.

We have a chance today to bring down inflation, first of all because its commodity component, reflecting shortages of food, raw materials, and the high price of oil, is likely to abate as demand and supply come into better balance. So far, the inflation of commodity prices has not yet been built into wage increases. American labor has shown remarkable restraint, reflecting presumably the recognition that the cost-of-living increases due to shortages cannot be made up, but can only be aggravated by an attempt to let wages catch up. But beyond a better demand-supply balance, we need restraint in our fiscal and monetary policies. High interest rates, which so many feel so severely today, will come down for good only if inflation lets up. Measures that would continue or aggravate the inflation, such as a tax cut, would also give us greater problems with interest rates.

The International Outlook

The United States, of course, is not the only country suffering from inflation. The problem is worldwide. But inflation proceeds at very different rates in different countries. That is to be expected, once the process gets going. The only rate of price change at which one might expect most of the major countries to move in step is a rate of zero.

Differential rates of price increase have contributed materially to the breakdown of the international monetary order and have prevented the restoration of an organized system. With prices rising at different rates everywhere, the competitiveness of producers in international trade becomes uncertain. Large deficits and surpluses develop in trade balances. These induce speculative movements of capital. Under such conditions, a system of fixed exchange rates cannot survive.

Some economists regard the present condition of floating rates as an ideal solution that ought to be made permanent. I regard it as simply another expedient that the world is employing because the strength is lacking for a more fundamental solution. Most countries do indeed want to return to a system in which exchange rates are stable, although they may have to be adjusted from time to time. But the domestic problems created by inflation, along with other causes, prevent countries from making commitments about exchange rates. Thus you find a major currency like the Deutschemark fluctuating against the dollar by something like 20 per cent in the course of one year, moving unpredictably in both directions.

Because the world has experienced a great boom, the uncertainties created by unstable exchange rates have had no adverse effects upon trade. No major country has found it necessary to protect its producers against foreign competition made more severe by depreciation of foreign currencies. No major country has felt it necessary to depreciate its own currency merely in order to give its producers a competitive edge. For the time being, in fact, countries have shown an interest in keeping their exchange rates high because that means cheaper imports and less inflation. But the time could come when at least some countries might see their interest lying in a different direction. Then international trade might begin to suffer from the prevailing currency instability. Trade controls would threaten.

One of the consequences of universal currency instability is a growing preoccupation of countries with their own domestic affairs. The world is becoming more inward looking. International economic cooperation, which was one of the success stories of the post World War II period, is becoming more difficult. Efforts to reconstruct the world's monetary system have made it clear that no country is in a mood to take forward looking action if this should involve serious risks in the immediate future. In the field of international trade relations, and of aid to developing countries, we see a similar weakening of the will to take farsighted action.

International turbulence has gone hand in hand with a decline in the international role of the United States. In all probability, the turbulence, and the inability to rise above it, are in good part a consequence of our declining role. Not long after World War II, during the early 1950's, the American GNP amounted to more than half of the GNP of the free world. The United States carried an economic weight in the world that enabled it to exert unquestioned leadership. We employed that leadership to create a system of stable exchange rates, of increasingly freer trade, and increasingly freer international investment. All the world benefited from this system.

Today the U.S. is no longer the giant among nations, as a book written by Peter Kenen then proclaimed. The Common Market is in the process of coalescing, although with many setbacks. Europe has not become a political reality, but economically it carries a weight in the world comparable to that of the United States. Japan meanwhile has been taking giant strides. American per capita income, once far ahead of every other country, is about to be caught up with by several European countries. All this explains why it has been impossible for the United States to maintain in the world that degree of consensus and common purpose that would be necessary to restore the international economic order. The U.S. is unlikely to recover that capability. Hereafter, it will have to be cooperation rather than leadership if a common purpose is to prevail.

How Much Change?

I have tried to show how, in various fields of economic policy, and in different parts of the world, the relentless pursuit of expediency threatens to undermine the enduring fabric of the economic system. I have said that we must strive to conserve that fabric even at some short-run cost. You will understand, of course, that for elected politicians it is not easy to follow this kind of advice. Their horizon is necessarily short -- often not beyond the next election. Economic measures that do not pay off by then are not very helpful to the politician. As Secretary of the Treasury George P. Shultz has said, the economist's lag may be the politician's catastrophe.

Nor can one blame the politicians for this attitude. After all, they do in the main what their constituents tell them to do. If the constituents had told them to preserve the price system, restrain the public sector, encourage saving and investment, stop inflation, and bring order back to the international economy, they would probably have done so. The means are at hand. That the means are not being used is in the first instance the fault of the voter, not of the politician or government official.

But in a deeper sense I suspect that the fault is not even that of the voter. The average voter, after all, does not have an easy time tracing long-term consequences to their short-run causes. Economists have struggled with these problems for centuries. Economics, to be sure, is a fallible science. Many of its propositions can be upset by unfavorable circumstances. Many recommendations can be challenged by value judgments. Nevertheless, on the major cause-and-effect sequences there is no disagreement. Few economists will tell you that price fixing will increase supplies. Not many believe that printing more money will bring down prices. Hardly anyone thinks that economic nationalism will increase the universal welfare. Thus, if economists nevertheless advise the public and the politicians to engage in practices of this sort, it is usually because they, too, are willing to sacrifice the long run to the short. In technical jargon, many economists, like most politicians, have a high time preference.

It should be one of the functions of economists precisely to bring better balance into this state of affairs. If the public and the politicians are inclined to stress short-run expediency, economists ought to throw their weight on the side of long-run principle. They should do this precisely because it is difficult for public and politicians to evaluate the long-run consequences of their short-run expedients. That is what I have been trying to do here tonight.

I would not want to leave with you the impression, however, that I think the future bleak because I find some things to criticize in the present. I am confident about the future of our economic order, partly because I believe that in the long run the good sense of people asserts itself and sets about to right matters, once a problem has been recognized as serious. I feel confident about our economic order also because that order in the past has proved remarkably resilient and durable.

Our economic order has changed over time, to be sure, but it has not changed very much. Where it had suffered a major breakdown, as during the depression of the 1930's, it has come back and continued to perform pretty much as it did in the past. Evidently there are strong recuperative powers and stabilizing mechanisms built into the system. How else would one explain that the rate of growth of the economy has hovered very stably in the range of 2-3 per cent per capita for many decades, leaving aside the effects of economic fluctuations? How else to explain the inglorious fact of the extraordinary stability of our income distribution, in the face of constant efforts to even it up? How else can one account for facts such as that over the last 50 or even 100 years the structure of our banking system has not changed very perceptibly, or that the relations between business and labor are still basically governed by a law originally passed in 1947?

Some people see change wherever they look, and change certainly is more interesting to write and talk about than is stability. I tend instead to see fashions, not to say fads, which quickly take hold of the public imagination and yield just as quickly to their successor. That certainly has been the history of the last 25 years. Looking ahead from 1948, few people probably would have believed that the U.S. would change as little as it has.

There are another 25 years or so to the end of the century. We cannot be sure that developments will not speed up over this time. Henry Adams probably was not the first to express the view that history tends to accelerate. Technology certainly has not disavowed him. During the last decade, moreover, our rate of social change does seem to have accelerated. Beginning with civil rights and the war on poverty, we have gone through a number of social movements that have followed quickly one after the other. But it is precisely this rapid rotation of what might have been major national initiatives that leads me to the conclusion that while intellectual fashions change, the underlying system is stable. I do not know whether, if by the year 2000 you find the old system still pretty much in effect, you ought to be pleased or not. But you ought not be surprised.