

FOR RELEASE ON DELIVERY  
THURSDAY, SEPTEMBER 25, 1980  
9:30 A.M. EDT

**THE UNITED STATES IN THE WORLD ECONOMY**

Remarks by

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

at the

**1981 Business Outlook Conference**

sponsored by

**The Conference Board**

**New York City**

**September 25, 1980**

THE UNITED STATES IN THE WORLD ECONOMY

Remarks by

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

at the

1981 Business Outlook Conference

sponsored by

The Conference Board

New York City

September 25, 1980

---

The time has long passed when a cold caught by the American economy would cause pneumonia in the rest of the world. While the American economy was slowing sharply, most of the rest of the world remained in reasonably good economic condition.

The new economic independence also works in reverse. Now that the United States' economy seems poised for recovery, a slowdown is beginning elsewhere. For overall stability, this lack of synchronization is beneficial. Fluctuations would be wider if they are synchronized internationally.

Unfortunately, this lack of synchronization does not seem to extend to prices. Around the world inflation accelerated when oil prices escalated. Now the lockstep is breaking, however, as deceleration sets in. While Japan, Germany and even Italy and the United Kingdom seem to be able to reduce their

inflation, the United States' price trend has been largely impervious to downward developments in the real sector. The best we can say about recent experience is that fears of an exploding spiral have been cooled. This threat has been averted. But disappointingly little seems to have been accomplished in reducing the underlying rate of inflation. If anything, a slight acceleration of wages has raised this rate. Meanwhile, expectations that inflation will continue at this level seem to have firmed up.

One might have thought that the severe break in economic activity would change price expectations. Certainly in combination with the very modest monetary growth targets of the Federal Reserve, the weakness of the real sector should have brought some dampening of inflation expectations. Perhaps this may still happen, since price effects usually tend to follow demand changes with some lag. This may be particularly so in the present situation, where the very early appearance of signs of recovery raises the question of a double dip. Whether this is the dominant probability is impossible to say at this time. But, in any event, it is too early to be altogether pessimistic on the price outlook. All one can say so far is that the drop in the CPI from its first quarter level of 18 percent to probably less than half of that in the third quarter, while it looks impressive, does not really reflect accurately the underlying realities. Inflation was not really 18 percent during the first quarter, and it will not really be as low as shown by the CPI in the third quarter.

What accounts for the difficulty in bringing down the underlying rate of inflation? One could cite many contributing factors including, I fear, a widely held suspicion that when the chips are down, government

action will again be found to favor rather than combat inflation. But there also seems to have been something about the nature of the recession, the trough of which we may be experiencing now: there never seems to have been enough uncertainty about the future to cause firms and households significantly to modify expectations and behavior. Dubious as economic forecasts have become -- including no doubt this one -- the present recession has been seemingly characterized by a widespread notion that it was not to be taken very seriously. Businessmen and consumers may be pessimistic about the long-run outlook, the future of the American economy, of their industry, of their own personal condition. But there seems to be a widespread feeling that after a short drop, the economy would resume speed -- or rather crawl -- and that nothing much would have changed. For the struggle against inflation, this mind set is extremely discouraging.

Our state of mind contrasts sharply with thinking in the countries that are successfully dealing with inflation, especially Germany and Japan. There seems to be a consensus that inflation must be defeated, and a belief that it will be done. Even in Britain, where success has at best been moderate so far, the evidence of political determination to make inflation the focus of government policy is still clear, probably because the British have had more time to realize that an economy in inflationary disarray cannot function.

In the United States, we have had evidence of this simple truth all around us for close to 15 years, but the lesson does not seem to have sunk in. We have talked about the need to bring inflation down but have allowed it to rise. Because we were always just about to take forceful

action to deal with inflation, we have always rejected dealing with its consequences. To do that, to make inflation less damaging, if we could not make it less virulent, would have meant, in conventional wisdom, to "throw in the towel." Action to alleviate the consequences of inflation, if it was maintained, would deprive the struggle against the condition itself of credibility. As a result, the United States probably has become the country where a given rate of inflation does more damage than anywhere else.

We have allowed inflation to have its full impact on saving and on investment, outside the real estate sector. We have allowed inflation grossly to dilute business profits, to the extent where many of the dividends paid are in effect liquidating dividends that ought to be nontaxable to the recipient if inflation-adjusted accounting were permitted for tax purposes. Some areas of the economy have in effect been indexed against inflation, such as wages, interest rates, the government sector, and single-family homes. Other areas, especially saving and business profits, have not had this kind of protection. The result has been a calamitous drop in productivity gains. We might be better off if we recognized the damage, allowed realistic inflation accounting, and, to the extent that we fail to reduce inflation, adjust our tax and financial system to minimize the damage.

None of this must be interpreted to imply that there are simple answers and that by a great effort of will we can pull ourselves out of the morass into which we have wandered. Our problems are not just cyclical,

those of recovering from recession or curbing a boom. They are deeply structural. We shall have to bear that in mind while we move to deal with recovery in conditions of rapid inflation.

I seem to observe a widespread view that inflation is bound to increase during an economic expansion, and that we are caught in a spiral in which each succeeding phase of expansion leads to inflation at a higher rate. While this has been our experience, there is no reason why we cannot learn from it. One lesson we can learn is to moderate the expansion. It is obviously much too late for stimulative measures to slow a downturn. Whatever is done now, in the areas of monetary policy, fiscal policy, and others will primarily influence the nature and speed of the upward phase of the business cycle. Because we are dealing principally with a structural rather than a cyclical problem, our measures should be shaped to that situation. Tax reform is urgently needed. But a premature tax cut that drives up the budget deficit and interest rates without reducing the size of the public sector can be very damaging. We would be moving toward a fiscal/monetary mix of easy budgets and tight money, exactly the opposite of what our economy needs if productivity is to recover.

If and when taxes are cut -- and in my judgment the later the better -- an opportunity would be created to make this cut dependent on better wage and price performance on the part of labor and business. In other words, there would be an opportunity for introducing a carrot version of TIP (tax-oriented incomes policy). The details of such a policy have been studied at length and need not concern us here. But the fact that

orthodox means of fighting inflation have not so far achieved striking success underscores the importance of resorting to new techniques, not to supplant, but to supplement them. It would be a pity to allow such an opportunity to go unused.

Monetary policy will have to stick firmly to its money supply targets, even though, as we have seen, this may sometimes lead to wide fluctuations in interest rates. Because we have a blessed recollection of very low interest rates, it is particularly hard for us to accept rates that are historically high. In many foreign economies, where capital has always been scarce, interest rates have never been low, in real terms. Moreover, the concept of real interest rates, that is to say after allowing for inflation, seems to be much more widely accepted abroad than it is in this country.

In particular, we seem to have difficulty realizing that interest rates must be evaluated not only after inflation, but after taxes. On reasonable calculations, it becomes evident that at the short-term end interest rates after inflation and taxes have been negative 60 percent of the time since 1960 and at the long-term end 65 percent of the time. Negative real interest rates both distort and overstimulate the economy. Countries that have successfully dealt with inflation generally have managed to avoid both mistakes. A stable rate of growth of the money supply, which in effect leaves the determination of interest rates to the market, offers the best prospect that negative real rates will be avoided most of the time, although some fluctuations in nominal interest rates probably are unavoidable.

Positive real interest rates look high in nominal terms and may have some tendency to slow economic expansion in the short run. This is the obverse of the familiar proposition that one can always, in the short run, stimulate the economy by making money a little cheaper and printing more of it. But in the longer run, negative real interest rates are a drag on the economy, just as past efforts to keep stimulating the economy have turned out to be. Expansion promoted by negative real interest rates would be artificial and shortlived.

If the United States follows moderate policies in moving out of the recession, leaving an amount of slack in the economy that under other circumstances one would want to eliminate, we have a good chance of changing inflation expectations and bringing down the inflation itself. We shall have to resist the temptation to accelerate economic growth to the rates that we used to welcome in the past. Measured in terms of GNP, the results would not compare favorably with many expansion periods of the past. But it would nevertheless be an exceptionally good period, because, by bringing down the inflation, we would be strengthening the structure of the economy and laying the foundations for future growth.

That growth is now limited by low productivity gains. This fact, as well as the need to maintain slack, requires us to be modest in what we ask of the economy. High productivity gains are not going to be restored overnight. Nevertheless, there now seems to be a broad-based recognition of the need to do something about productivity. Bringing inflation down is one part of the game. The other consists of a wide range of actions in the



areas of taxes, regulation, research and development, and others that are likely to receive increasing recognition. There appears to be a greater prospect now than a year or two ago that in some of these fields some of the right things will be done. If that turns out to be a correct forecast, the United States can look forward to seeing its growth restored at least to some semblance of former levels.

#

## Summary of Remarks

1. The United States is poised for economic expansion while the rest of the world is slowing. This will help to prevent extreme fluctuations in the world economy.

2. Inflation measured by the consumer price index has been more than cut in half, but a significant improvement in the underlying rate of inflation is not yet observable. We may, therefore, start the next expansion from a substantially higher base of inflation.

3. The United States has made itself extremely vulnerable to inflation by allowing large sectors of the economy, such as wages, interest rates and housing, to become effectively indexed while leaving saving and profits at the mercy of inflation. Severe damage to productivity is the result.

4. Our main economic problems are not those of boom and recession but of a structural nature. They will take time to remedy, and call for measures other than monetary policy.

5. Tax reform is urgent, but a tax cut now would be premature and would push us toward an undesirable combination of easy budgets and tight money.

6. A tax cut, if and when it comes, could be made the opportunity for introducing a tax-oriented incomes policy.

7. To avoid a new upsurge of inflation from its present high level and to wind down the inflation over time, the recovery will have to be kept moderate and some slack maintained in the economy.