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Remarks by

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

at a conference on

"Financial Markets and Economic Activity"

sponsored by the First Austrian Bank

Vienna, Austria

Thursday, April 14, 1983

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With admirable foresight, the sponsors of this meeting, to whom I extend thanks, have issued their invitations at a point in time when it can be said with some assurance that, in the United States at least, an expansion seems to be in progress. This is an important development. Nevertheless, even though most of the world's economies are likely to move up hereafter, we are still experiencing the consequences, often painful, of events and policies that now lie in the past, but that for better or for worse will continue to shape our affairs for a good while longer. That is the reason for examining the legacy of the 1970's. I am grateful to our hosts for giving me an opportunity to survey such a broad panorama of economic history and outlook.

The 1970's was a period of disillusionment, of loss of faith in seemingly established truths. Confidence was lost in the stability of prices and exchange rates. More than that, we lost faith in the willingness

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of governments to make serious efforts to preserve or restore stability. As governments lost credibility, so did some of the established doctrines about the functioning of the economy. New doctrines, themselves often of questionable plausibility, began to take their place. It has been difficult to keep one's bearing under these conditions.

Nevertheless, not all our experience of the 1970's was adverse. And it must be remembered that in the face of very considerable difficulties, the world economy continued to make progress, raising average living standards particularly in the developing world. Progress, however, has slowed down very perceptibly. In many countries it has come to a total halt. If we can learn from our experience, we ought to do better hereafter.

Inflation

Virtually all industrial countries experienced serious inflation during the 1970's, although in different degree. Determination to resist inflation and return to price stability has often been interpreted in terms of each country's earlier inflation experience. Austria and Germany both suffered inflations so severe that the money supply was totally destroyed and so were most financial savings. The good performance of these two countries in combatting the inflation of the 1970's probably reflects that earlier experience.

The United States and Great Britain, as well as the Scandinavian countries, have been spared similar experiences. As a result, they seem to have been more susceptible to the recent assault of the inflation virus. For a long time, inflation in these countries was regarded as a minor evil,

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and as a price well worth paying for fuller employment. It took time to learn that inflation is not only costly and painful, but that in the long run it undermines rather than supports the full-employment objective. It took high rates of inflation, although far from the hyperinflations experienced by Austria and Germany, to drive home that lesson. One may hope that the lesson has been learned, but it would be premature to be sure.

Other countries, such as France and Italy, years ago experienced rates of inflation that fell short of totally destroying the money supply but nevertheless sufficed to destroy financial savings. It is not at all evident that that lesson has dominated attitudes and policies. Finally, there is the example of Switzerland, which has had no historical experience of high inflation and nevertheless has resisted inflation more vigorously and successfully than any other country. Thus, historical experience of inflation, while important, does not seem to be a reliable indicator of a country's present day determination to achieve price stability.

The causes of inflation have, of course, been many, and often quite different in different countries. But making all possible allowance for oil shocks, imported inflation and other circumstances difficult to control, the principal cause almost everywhere seems to have been an effort to drive the economy harder than it could safely be driven. Economists, particularly those of the Keynesian persuasion, must accept a great deal of responsibility for these policies. To be sure, more mundane political pressures might have done a similar job without benefit of economic theory. Whatever the causes and circumstances, one effect of inflation has been a loss of faith in price stability as a normal condition. This has greatly increased the cost of

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economic activity. Buyers and sellers, employers and employees, lenders and borrowers must charge some kind of a premium to cover the risk that an unexpected movement of prices, to their disadvantage, would falsify their calculations. Both sides suffer as it becomes harder to interpret the movements of individual prices and the general price level. The most damaging aspect of the uncertainties posed by inflation probably is the great difficulty it creates for people who want to provide for their future. Remarkably, people continue to save and did so even when real interest rates were negative. Indeed, some people seem to save more than they might if price stability were assured because they need to guard against this insecurity. But predominantly the effect seems to have been to drive people to rely on government protection for their retirement, as the only seemingly sure way of guarding against destitution in old age. It is hard to imagine a more serious defect in civilized society than inability to provide for the future.

It is not unreasonable to hope, given past experience, that the lessons have been learned and that inflation in the future will be much more moderate or entirely quiescent. But the generation that has lived through the 1970's, with their rapid shrinkage in the value of money, probably has been scarred for life. In the United States, a survey of financial managers suggests that most of them do not expect a high rate of inflation over the next 10 years. Nevertheless, on average, they give a probability of about one-third to the possibility of hyperinflation. It will take long years of reasonable price stability before these memories of the 1970's will fade.

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Meanwhile, better techniques of preventing inflation and of bringing it down once it has taken hold seem to have been developed. Most countries have shown enough wisdom to avoid wage and price controls, which usually are effective for at most a short period, do much damage while they last, and have no permanent impact on the rate of inflation. Most countries have found that the ordinary techniques of central banks in manipulating interest rates are not adequate against inflation. Moreover, many have found that the ability of central banks to influence interest rates is very much diminished in an inflationary environment. Money-supply targets have proved to be more visibly related to the rate of inflation and less susceptible to gross error. They have also helped to shield the central bank against the criticism that would be associated with a policy of setting interest rates high enough to curb inflation. By and large, money-supply targets have proved effective in reducing inflation, although they have sometimes had unexpected and costly side effects.

A central bank need not subscribe to the tenets of monetarism in order to follow a money-supply policy. Indeed, monetarism, while it has acquired great merit by promoting money-supply targeting, has not served the cause of anti-inflationary policy well by claiming that monetary over-expansion is the sole cause of inflation and that no other instrument but monetary restraint needs to be employed to bring inflation down. This has contributed to the prevailing lack of concern over large budget deficits. For governments, of course, news that budget deficits are not inflationary is welcome. The ensuing higher real interest rates can readily be blamed on the central bank.

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Excessive reliance on monetary policy as an anti-inflation weapon has also contributed to discouraging the development of incomes policies. To be sure, even in the not many cases where they seem to have worked, incomes policies have been in no way a substitute for monetary restraint. Nevertheless, they could reduce the costs associated with monetary restraint. If fiscal policy and incomes policy had been employed more effectively, both unemployment and interest rates probably would have been lower. The development of viable incomes policies has to be carried over to the agenda for the 1980's. It should be clear that they should in no way rest on wage and price controls, but, on the contrary, require a heightened degree of cooperation between business and labor.

Interest Rates

One of the legacies of the 1970's -- and early 1980's -- is a high level of interest rates. During most of the 1970's, however, interest rates were far from high. As the rate of inflation, with some ups and downs, moved up during the decade, most interest rates became negative in real terms. Short-term rates frequently were below the current rate of inflation, long-term rates below what might reasonably be regarded as expected inflation. This condition contributed to excessive borrowing, monetary expansion, and further inflation.

During the early 1970's, the tendency of interest rates to move closely with the rate of inflation was far less pronounced than it is today. This relationship was even looser during the inflationary periods of the 1940's and 1950's. Interest rates were believed, on historical evidence

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going back to the 19th century, to follow inflation only with a lag of many years. Gradually, as both borrowers and lenders began to understand better the effects of inflation on the cost of money, a much closer relationship developed. By 1980 or 1981, with the help of hardening monetary policies in the United States and elsewhere, positive real interest rates had become the rule, i.e., interest rates tended to exceed the rate of inflation.

One may view this development, within limits, as an improvement in the allocative function of interest. One may view it also as a victory, for the time being, of the saver over the borrower. Previously, savers had in effect been expropriated by borrowers. And one may view it as a victory of the old, who in part live on savings, over the young, who tend to be borrowers. In that sense, it could reflect the beginning of an ominous shift in the balance of numbers and the associated balance of political influence away from the young who work and toward the old who in some form must be supported by them. That balance can be expected to change further during the 1980's and indeed as far ahead as demographers can see.

The combination of inflation with a tax system that did not recognize it seriously distorted the economic effect of interest rates. The saver did not get the full benefit of the inflation premium in the interest rate, because both real interest and the inflation premium were taxable. Borrowers generally were able to deduct, for tax purposes, the full nominal interest premium. This introduced a further upward bias into nominal interest rates. It also conveyed a false picture of seeming enrichment of interest recipients through high rates, when in fact these rates in part constituted amortization of a depreciating principal.

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The financial structure of business was distorted during the 1970's by the interaction of interest rates, inflation, and tax deductibility. Debt financing increasingly predominated over equity financing. Short-term and floating-interest-rate debt gained at the expense of long-term and fixed-rate debt. Businesses, as well as home buyers and developing countries that borrowed heavily, became increasingly vulnerable to interest-rate fluctuations. The share of capital in national income shifted toward interest and away from profit. All this depressed the willingness to invest, despite negative real rates, as well as the rate of economic growth.

The rise in interest rates was further exacerbated, as already noted, by mounting government deficits. At times during the 1970's, this tendency was counteracted by the large supply of saving that entered world capital markets from OPEC. But OPEC surpluses disappeared quite soon after each of the two great jumps in oil prices. It is worth noting that the deficit in the U.S. budget now is approximately twice as large as the OPEC surplus was at its peak.

The ability of central banks to influence interest rates diminished as interest rates became increasingly responsive to inflation and inflation expectations. This consequence was enhanced by the variability of exchange rates under the floating-rate system, to which I shall presently refer.

For the 1980's there are good prospects that interest rates will decline, both nominal and real. Nominal interest rates should decline as inflation and inflation expectations diminish. Real interest rates would decline if the balance of saving and borrowing were to move in a favorable direction. Some contribution to that end may come from a resurgence of

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saving, as confidence in price stability rises. The principal contribution to lower interest rates, however, which quantitatively can far outweigh any likely increase in private saving, would have to come from a reduction in government deficits.

Exchange Rates

Floating exchange rates are another legacy of the 1970's. When they were imposed on the world by the collapse of the fixed-rate system, it was widely argued that from now on individual countries would be able to conduct the monetary and fiscal policies they preferred. Each country simply would accept the resulting rate of inflation, and so free itself from the policy constraints that flow from the need to preserve fixed rates. This turned out to be an error. Exchange rates proved very sensitive to even minor variations in policy. The cost of rate movements in terms of inflation if currencies went down and in loss of competitiveness when they went up proved severe. Many countries found that they were better off voluntarily limiting their policy freedom and preserving more or less stable exchange relationships with their main trade partners.

Floating exchange rates performed another service for which they may not have received enough credit. When the Bretton Woods system broke down, there was indeed a policy alternative to floating. It was to follow the pattern of the 1930's and maintain fixed rates by means of exchange controls. During the 1930's, after the gold standard had broken down, this alternative was chosen by many European countries in preference to floating. Flexible rates, it was then thought, might lead to inflation and disorder.

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In the event, exchange control during the 1930's led to a drastic shrinkage of trade, widespread cessation of free capital movements, and default on international debts. Avoiding such consequences in the 1970's probably was well worth the cost that floating rates have exacted in other respects.

Exchange-rate fluctuations, it turned out, were a great deal wider than had been expected. These ups and downs were far more also than could readily be explained by differential movements in rates of inflation. Thus, competitive relationships and current-account balances varied alarmingly. Nor were bankers, economists, and other experts seemingly at all successful in predicting future rate movements. The important role played by interest-rate differentials, current-account balances, and rates of inflation in determining exchange rates was generally agreed. But their relative weight and quantitative effect seemed to change unpredictably.

Nor did it seem possible to ameliorate exchange-rate fluctuations substantially by means of intervention. Very heavy intervention did indeed take place on occasion. When it was supported by monetary-policy action, rates responded. Most intervention indeed has monetary effects, through its influence on bank reserves. But if that influence is sterilized by central-bank open-market operations, as is routinely the case in the United States, the remaining effect on the exchange rate is modest.

Wide rate fluctuations have proved troublesome because of their impact on competitiveness. When a country's currency is high, protectionist pressures are likely to develop. In the end, this might lead to the same kinds of controls that an attempt to maintain inappropriate fixed rates also could provoke.

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The volatility of exchange rates has been further enhanced by the unintended consequences of money-supply targeting. Under money-supply targeting, interest rates and, therefore, exchange rates are likely to be more volatile. To reduce volatility, money-supply targeting would have to be given up, or at least modified. Then it might be possible to coordinate interest rates internationally and so make exchange rates more stable. But giving up money-supply targets might mean giving up the prospect of controlling inflation. Not only would that be a very high price to pay for diminished exchange-rate fluctuations. It would also introduce a new destabilizing factor into exchange rates.

Nevertheless, it is evident that, among the countries of the European Monetary System (EMS), wide swings in exchange rates have been avoided. Changes in EMS rates have been frequent. But they have generally been in the direction likely to produce more balanced current accounts. There have been very few rate changes in one direction that soon were reversed by a contrary movement, as has happened where rates have been floating freely. Given the volatility of rates outside the EMS, this must be adjudged a considerable advantage. Moreover, the Bundesbank, for instance, has been able to reconcile the pursuit of its money-supply target with such degree of stability as currencies in the EMS have had. This may be a special situation attributable to the unique role of the D-mark in the EMS. But it may also hold broader lessons for money-supply targeting in general.

As inflation diminishes all around, the volatility of exchange rates should also diminish. At this time, a common effort to move toward domestic stability seems to be the most promising form of international cooperation

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that is feasible. Each country, by putting its own house in better order, can contribute to the stability of exchange rates generally.

Unemployment

The unhappiest legacy of the 1970's is the high level of unemployment. Though differing in degree, unemployment is pervasive around the world. Even countries that, by international standards, might be regarded as having little unemployment, by their own standards perceive their unemployment to be high. But while unemployment is troublesome everywhere, the circumstances and processes by which it reached present levels have differed among countries. In the United States, for instance, the 1970's saw very little increase in real wages. There was an increase in the number of jobs, however, of about 20 million, or almost 25 percent of the 1970 total labor force, which in turn increased 28 percent. U.S. employment, therefore, was associated with a very large increase both in employment and in the labor force. Only a minor part of the labor-force increase was not fully absorbed into employment. This labor-force increase resulted both from demographic factors -- the baby boom of the 1950's -- and from massive increases in the number of working women. The flood of untrained new workers may also have had something to do with the low level of productivity gains. Because real wage increases were about commensurate with productivity gains, both being very low, the shares of capital and labor in national income did not change much.

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In Europe, on average, unemployment developed under different circumstances. Real wages grew substantially. The labor force grew only moderately. New job creation was relatively low. Productivity gains, however, fell well below the rate of increase in real wages. As a result, the distribution of national income between capital and labor shifted in favor of labor. These facts may contain some hints as to at least one of the causes of high European unemployment -- the size of real wage settlements. Ordinarily, settlements are in large measure determined by productivity gains. But when real wage gains depart substantially from productivity gains, other factors evidently also have an influence. One of them is the forcefulness with which labor pursues its demands for higher wages. When real wages move significantly ahead of productivity, it is bard to avoid the conclusion that there has been strong pressure on the part of labor and that this has been a reason, perhaps only one of several, for rising unemployment. This seems to have been the case of many European countries.

In the United States, the simultaneous stagnation of real wages and productivity suggests that pressure for higher real wages was more moderate. This probably helped to absorb the large increase in the labor force and to keep that increase from pushing unemployment even higher. In comparing unemployment levels in Europe and in the United States, it needs to be remembered that the U.S. unemployment count rests on household surveys rather than, as in Europe, a count of registered unemployed, and so typically yields higher numbers.

The most pressing economic and social issue facing the 1980's is the reduction of unemployment. Its level almost everywhere is so high that there is no immediate need to focus on how far it should and can be reduced.

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In the United States it has come to be realized that the noninflationary level of unemployment unfortunately is higher today than it was in the past. It is also considerably higher than was thought in the mid-1960's before the outbreak of inflation indicated that unemployment levels of 4 percent or less even then were not sustainable without important structural changes in labor markets. In any case, however, today's U.S. unemployment level of about 10-1/2 percent is far above the noninflationary level, which often now is placed in the range of 6 to 7 percent. That leaves a very substantial amount of unemployment to be remedied.

What is the best method of doing this? The question confronts both Europe and the United States, but I seem to hear somewhat different answers. In the United States, it is generally expected that the economy will expand sufficiently to provide the needed jobs. During the 1980's, the United States faces a much more favorable labor-force situation than in the 1970's. The bulge of the baby boom is largely behind us, and the labor force therefore will grow less rapidly. The many new entrants of the 1970's will have acquired some experience, will be more easily placeable, and will contribute more to productivity. There is little talk in the United States, therefore, of sharing the work by reducing hours worked. Indeed, recent social security legislation raises the retirement age, thus tending to increase the labor force. We are aware, of course, that to "share the work" would limit output and growth, and almost certainly would reignite inflation. It seems unlikely that a reduction in hours could be accomplished without some increase in hourly pay and benefits in order to give the appearance of compensating at least in part for the individual income loss.

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In Europe, I hear somewhat different views. There seems to be a good deal of discussion of shorter hours, matched by not very clearly defined changes in hourly pay and weekly take-home pay. Of course, I cannot judge the reasons for taking this different approach, but I see many advantages in the American approach.

Conclusion

In conclusion, as I look at the legacy of the 1970's and what it means for the 1980's, I find myself moderately hopeful. The 1980's have many advantages over the 1970's. We entered the 1970's with great expectations, and we were disappointed. We entered them with belief in the natural and permanent stability of things like price levels, interest rates, exchange rates, and asset values, and we were disabused. As a result, we have lost our money illusion. That in some respects makes it harder today for governments and central banks to do their job. It is always easier to conduct economic policy when people do not notice an ongoing moderate inflation. But the better understanding of these things by the citizens, and the resultant prompter reaction of markets to inadequate government response, is a more fundamental gain. We know now that things are not going to be easy. But I think that we also know better now what we must do.

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