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REMARKS BY

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As we approach the fall political season, discussions of economic affairs seem increasingly to highlight conflict and disagreement. There is an understandable tendency to point only to the pluses or to aggregate the minuses of the current economy; thus to paint only the rosier or the blackest pictures of the outlook. Still, underlying all the rhetoric is, I believe, a basic consensus on what the economic policy goals for our nation should be. There is a widespread desire to reestablish a path of sustainable economic growth in which rising incomes generate greater spending and saving--which in turn create more jobs. There also is general agreement that these gains will be lasting only if greater prosperity is achieved without igniting a new inflationary spiral.

Furthermore, it is widely recognized that progress on many fronts is needed to attain these goals. From the private sector we have to see a cooperative effort by management and labor to increase productivity and reduce costs. Such measures are absolutely essential if American industry is to compete successfully in international markets and create the jobs to employ a growing labor force. From government we must have policies that create a positive economic environment and provide the right incentives for the private sector. Higher after tax rates of return on investment are needed. This means responsible and consistent fiscal and monetary policies, coupled with a regulatory framework conducive to competition and efficiency.

Today, I would like to address the role of monetary policy in promoting a healthy economy. First, I want to make clear the current objectives

of monetary policy in light of the progress we have made in reducing inflation. I also think it is important to discuss how we are going about achieving those objectives. Finally, I would like to look into the near future to see what we can reasonably expect to achieve.

Recent Developments in Perspective

During the 1960s and 1970s, forces acted in both subtle and not-so-subtle ways to build inflation into our economy. As the momentum of wage and price advances built and became deeply ingrained in contracts and psychology, the process of checking inflation became ever more difficult. The severe economic problems that have faced the business community and the public at large during the past several years are the unfortunate transitional costs of reversing that inflationary process. Real gross national product has not expanded on balance since 1979, as a policy of restraint has dampened price increases only after leaving its marks on output and employment.

As a result, finding and keeping a job has become a major concern, with the unemployment rate rising to a post-World War II high of nearly 10 percent. The shift from manufacturing to a "knowledge intensive" labor force continues to be painful. Even for many with jobs, these have been far from the best of times. For instance, finding the wherewithal to buy a home or a new car has become a more difficult task for many young families. Family real wage gains came to a halt in the 1970s.

The lack of economic growth also has meant lower sales and profits for businesses. Balance sheets have been severely strained, as reduced cash flow has forced firms to turn to credit markets at a time when the cost of borrowing is quite high in historical perspective. At the extreme, the poor economic performance of recent years has contributed to the bankruptcy or

reorganization of several major companies. Moreover, many small firms also have been hurt badly. Overall business failures this year have climbed to their highest levels since the early Thirties.

Financial institutions also have been under considerable strain. The problems of thrift institutions are well known. The industry has a portfolio laden with old long-term, low-yield mortgages, while its cost of funds is largely tied to higher interest rates in the market. It is estimated that FSLIC-insured savings and loan associations alone sustained operating losses of more than \$4-1/2 billion last year and in the vicinity of \$3 billion during the first half of 1982. The industry experienced approximately 300 mergers in 1981 (many of which were assisted by regulators), and the trend has continued into this year. Other financial institutions have been affected to a lesser degree by the stresses that record interest rates and sharp movements in yields have placed upon them during the past few years; however, there have been some notable failures in which managerial problems played a key role.

The financial dislocations involved in the business failures that have occurred have hurt a small number of banks. The recent financial difficulties in Mexico--and heightened concerns about other foreign credits--have added to the pressures on the banking system in the United States. Despite these acute problems, the uncertainties of current financial markets, and the generally adverse economic climate, the number of commercial banks recording deeply depressed operating results has remained small. Overall, the banking system has coped well with these stresses, despite having to deal simultaneously with increasing competition and the ongoing deregulation of deposit markets.

Against the backdrop of all these problems we have confronted, and continue to face, there has been a growing recognition--at least in some circles--of the successes of anti-inflation policies. Specifically, I believe the recent dramatic decline in interest rates and the rebound in stock prices are measures of renewed optimism about prospects for the economy. Data on price movements have been quite favorable. Financial market participants have, I believe, correctly recognized these developments as the groundwork for continued and permanent progress in purging the economy of inflation. In addition, the recent tax legislation made desirable progress toward alleviating a serious fiscal imbalance; this Congressional action in an election year has reduced some anxieties about potential financing burdens and the inflationary dangers of large federal deficits. Of course, if favorable financial market trends are to be sustained and extended, we must continue the progress toward price stability.

I believe there is good reason for hope on that score. The evidence of a turnabout in inflation is persuasive. Prices of raw industrial commodities, on average, have fallen by about a fourth in the last 2-1/2 years; in the prior 2-1/2 years, they had risen by about 60 percent. Consumer price increases--after having been in the double-digit range for some time--also have moderated. The consumer price index has risen at an annualized rate of 5-1/4 percent on average thus far this year. And, the price index for GNP--which is one of our broadest measures of price performance--slowed to a 4-1/2 percent annual rate during the first two quarters.

Some of these gains could be attributed to luck, with agricultural products in ample supply--indeed, too ample from the standpoint of many farmers--

and with no negative major disruptions to world crude oil production. The recent moderation in price pressures also reflects the effects of cyclical weakness in the national and the world economy. Looking at the total picture, however, the slowing of price increases has been too pervasive to be attributed to good fortune or transitory factors.

Furthermore--and this is a particularly favorable sign--labor cost increases have moderated substantially. Average wage increases--which peaked at rates of increase of around 10 percent in late 1980 and early 1981--have fallen to a range of 6 to 7 percent so far this year. These wage increases are still much greater than gains in productivity, but they are down to a pace not sustained since the late 1960s and early 1970s. In addition, there have been some striking changes in traditional labor market practices in several key industries, changes made with a view toward holding down costs and increasing productivity. Management and workers alike have reconsidered planned wage adjustments. The postwar "improvement factor" of 3 percent or so built into contract negotiations has become less automatic. Some contracts have been renegotiated well in advance of termination dates, and a number of labor agreements have been modified in an effort to ease cost pressures. Management has made concessions. Work rules have been adjusted, and in some cases reductions in paid leave have been accepted. While fundamental improvements in productivity can be masked by suboptimal levels of capacity utilization during a period of business decline, these efforts should have noticeable results as the economy picks up.

Unfortunately, this progress in reducing inflation leaves us still well short of our goal. In fact, public opinion polls suggest that there is not even a general appreciation of the progress that has been made. This really

underscores a critical point: if we are to extend the gains we have made, an alteration of expectations must be achieved. I'm sure that you all recognize that, over a decade and a half, inflation became deeply embedded in everyone's thinking and planning. As people anticipated that inflation would continue, they built their expectations into wage dealings and business contracts. Thus, not only must the rate of inflation be brought down, but families, businessmen, and labor organizations all have to be convinced that slower price increases are permanent.

Given the strength of the inflationary expectations that developed over a span of more than a decade, it is not surprising that people may not believe that the recent favorable news on the price front is permanent. Notwithstanding the declines of recent weeks, the persistence of historically high long-term interest rates suggests that investors continue to harbor fears that inflation may return. To some extent experience with past ups and downs in the rate of inflation has taught people to be skeptical. Think of an investor who bought bonds in 1976, with inflation at 5 percent! Another factor could very well be the feeling that anti-inflation policies--policies that have had distressing economic costs--will not be pursued to their proper conclusions.

In my view, a serious commitment to the restoration of reasonably stable prices does exist in Washington. It is important that people get and heed that message, for if they act on a different assumption they will be exposing themselves to risks of economic loss. And, taking a more positive view, just as expectations of more inflation made inflation worse, once expectations of persistent slowing in inflation take hold fully we can gain the benefits of reinforcing a cycle of wage-price moderation.

Monetary policy: where we stand

Monetary policy obviously has a crucial role to play in bringing about this highly desirable disinflationary process. Maintenance of a disciplined policy toward the growth of money and credit is a necessary condition for the containment of price pressures. Excessive money growth would intensify inflationary expectations, would lead to renewed rapid price and wage increases, and would--before long--reverse the progress we have made in lowering interest rates. Private demands for credit would once again be driven by anticipation of ever higher prices, and savings would be discouraged. In short, we would be back in a destructive inflationary spiral. This would be unfair to all those who have suffered from the economic problems we have experienced and would no doubt precipitate even more severe difficulties in the future.

Nonetheless, the Federal Reserve recognizes the need to promote higher levels of production and employment. A major objective of current monetary policy is to create an environment conducive to a sustained recovery in business activity while maintaining the financial discipline needed to restore reasonable price stability. In line with that aim, we have indicated that it is appropriate to expect monetary growth in 1982 to be around the upper ends of the ranges we adopted at the beginning of this year. This would represent a significant reduction in the rate of monetary expansion from the pace of the late 1970s. On a very preliminary basis, we have indicated that the money supply growth ranges for 1983 might be the same as this year; we'll be reassessing that early next year in light of further developments. Given the anticipated increases in money this year, retention of the same ranges for 1983 would, of course, be quite

consistent with some further deceleration in the trend growth of money. We believe our policy course will support the resumption of economic growth at a moderate--and sustainable--pace as inflation continues to wind down.

Even when the objectives of monetary policy are clearly stated, our actions are often misinterpreted. And the chance of misunderstanding has increased in recent years, as the conduct of monetary policy has become increasingly complex and difficult. The challenges we face in carrying out policy have been intensified by the fact that financial markets and institutions are changing rapidly, reflecting both technical innovations and deregulation. In executing monetary policy, the Federal Reserve necessarily relies on established, historical relationships between measures of money, interest rates, and economic activity. The rapid evolution of new institutions, the proliferation of financial instruments, and the development of uncharted relationships all have necessitated conducting policy with some degree of flexibility.

All of these problems, I might note, are--at least in theory--separable from some much publicized operational issues involving the way we seek to control the growth of the money supply. The Federal Reserve has been targeting the growth of the monetary aggregates for some time. However, in October 1979, operating procedures were changed to achieve more effective control over growth of the money supply. Emphasis was shifted away from short-term interest rates toward controlling the growth of reserves that banks and other depository institutions hold against their deposits. Those changes were not the final word and the System continues to seek improvements in its control mechanism. For example, the Board has agreed in principle

to adopt a plan for contemporaneous reserve accounting. Because such a system would require depository institutions to satisfy their reserve requirements sooner than under the current system of lagged settlement, tighter short-run monetary control should be possible. The technical details--as well as the date of implementation--have yet to be worked out. The Board will be meeting shortly to deal further with these issues.

Despite the improvements in our procedures, the Federal Reserve is still faced with the more fundamental problem of defining and specifying the monetary targets necessary to meet our objectives. I won't attempt to give a comprehensive treatment of this subject, but I think a few brief remarks are worthwhile. Some of the major complications we have faced--and may have to deal with in the future--have resulted from the development of new financial instruments. During the past several years, for example, there has been rapid growth in money market mutual funds and in NOW accounts. The old definitions of various monetary aggregates became less useful, and it became necessary to account for the development and increased use of these instruments. In the future, we may face problems associated with the effects of so-called "sweep" accounts in which deposit balances over a set minimum are shifted automatically into income-earning assets on a daily or weekly basis. This type of service previously was offered to only a relatively few affluent customers, but it's becoming more widely available as institutions face up to the competition from money market funds for the savings of an increasingly sophisticated public.

These innovations are examples of why measures of the money supply must be altered from time to time. And even after we make allowance for

changing financial instruments, the relationships among different measures of the money supply and the variables such as GNP growth that represent the ultimate concerns of economic policy can change drastically. We have responded to these problems in two principal ways: we target more than one aggregate, attempting as best we know how to understand and predict their overall growth and interrelationships; and we specify our targets as ranges, thereby recognizing the imprecision of relationships and facilitating small mid-course corrections.

The same financial innovations that have made it necessary to be flexible in setting growth targets have added to the need for flexibility and adjustments in our everyday operations. The increased mobility of funds among a larger number of instruments just adds to the normal complexity--and the potential volatility--in financial relationships during any given period. The Federal Reserve knows that there is an inherent volatility in the various measures of the money supply on a week-to-week or even on a month-to-month basis. We keep these short-run movements in perspective and urge others to do likewise. Reflecting this viewpoint, we are considering publishing the money supply figures as four-week moving averages rather than as single-week data; we are in the process of assessing the technical problems of implementing such a procedure, including the possible need to alter techniques of seasonal adjustment.

But apart from the basic short-run "noise" in money supply movements, there may be other reasons to tolerate temporary deviations from announced policy goals. For instance, earlier this year the Federal Reserve observed an apparent surge in the desire of businesses and individuals to hold assets in relatively liquid forms. It has been the view of the Federal

Reserve that the resultant growth in NOW accounts and other liquid balances was largely for precautionary reasons rather than for transactions purposes. Thus, the faster growth of such accounts was not judged to be inflationary. Efforts to achieve immediate and fully offsetting reductions in the monetary aggregates, consequently, would have been wrenching to the markets, driven up interest rates, and resulted in a tighter monetary policy than intended by our longer-run targets.

Let me summarize what I've said about the difficulties involved in implementing monetary policy by returning to where I started on this topic: the vast changes underway in financial markets. These changes have complicated the way the Federal Reserve translates its objectives into actions. They also have complicated any measure of our effectiveness. There is, unfortunately, no simple way for you to judge our performance-- just as there is no simple way that the Fed can conduct monetary policy. We will do our best to explain publicly what we are doing. At the same time, we ask that you do not fall prey to simplistic analyses of how well we are doing.

Before leaving the topic of how monetary policy is being conducted, I'd like to comment briefly on some current initiatives in Congress which would explicitly require targeting interest rates as a monetary policy goal. Some versions would have us focus on so-called real interest rates, that is, interest rates adjusted for inflation expectations. In addition to a multitude of technical problems--like defining the appropriate rate and managing to control it--it seems to me that these suggestions generally have more fundamental and dangerous flaws. Importantly, we must ask whether in today's environment

the Fed can simply push interest rates down by a rapid and substantial increase in bank reserves and monetary aggregates without running a serious risk of stimulating inflationary money growth. The answer clearly is no. These proposals no doubt reflect a genuine and understandable wish to lower the cost of credit. One must be extremely careful, however, to distinguish between serious technical discussions about monetary targets and suggestions that are merely a vehicle for changing policy objectives toward easy money.

Concluding remarks

I need not spend a great deal of time recounting the lingering costs of rapid inflation. The persistence of historically high long-term interest rates tells the story well enough. And the uneven burdens of the disinflationary process in the economy also are very striking. Credit-sensitive sectors--most obviously the housing industry, but others too--are paying a heavy price. Those who suffer particular hardship are the workers who are part of post-war record unemployment.

It is clear that we cannot afford to return to an environment in which prices are rising at double-digit rates and distorting economic decisions, in which homes--viewed as a way of "beating" inflation --are inflating at 20 percent annual rates and pricing many young families out of the market; in which speculative activity is the norm, faith in the financial system wavers, and saving is an inferior strategy to borrowing.

To avoid a rekindling of inflation, we need sensible monetary and fiscal policies. I want you to know that the Federal Reserve clearly is committed to doing its part. Although recent progress on the fiscal side is encouraging, much more needs to be done. Federal deficits--projected

to be well in excess of \$115 billion this fiscal year and next--place tremendous pressures on financial markets. Of total funds raised in credit markets this year, the amount borrowed under federal auspices--including government-related agencies and guaranteed loans--could well be in excess of 50 percent.

To be sure, much of the large deficit can be attributed to the effect of the current economic downturn on the budget; however, a good part is "structural" in nature. That is, a significant proportion of the deficit reflects an imbalance, a sort of "black hole" between receipts and expenditures that would exist even in a satisfactorily growing economy. Under current budget plans--which have still to be implemented in the appropriations process--this structural element probably will be as large in fiscal year 1983 as this year.

Further action to place the federal budget on a clear-cut trajectory toward balance would do much to reduce the pressures on financial markets that have kept interest rates at high levels. People will become less worried that eventually the burden of federal borrowing will lead the Federal Reserve to an inflationary "monetization" of the debt. More directly, by releasing funds for private sector use, lower deficits would relieve the threat of crowding out credit-dependent sectors and release the resources so necessary to solve many of the fundamental problems facing our economy. Specifically, it would give the newly-enacted tax incentives a chance to work, to stimulate investments that will enhance productivity. Increased productivity would, in turn, help restore the competitive position of U.S. firms and generate the real income growth that feeds back into more jobs and economic growth.

In short, we have to get the economy back on a path toward prosperity. We will not do this by responding in this time of trial with a change in the direction of our policies. Rather, we must recognize that the path we have been on is fundamentally right, that it is working, and that with a measure of persistence and patience we can look forward to reaping the very substantial rewards of our efforts to turn the tide of inflation and rebuild our nation's economic strength.

CHART 1

PRICES OF RAW INDUSTRIAL COMMODITIES



CHART 2
BROADER MEASURES OF INFLATION

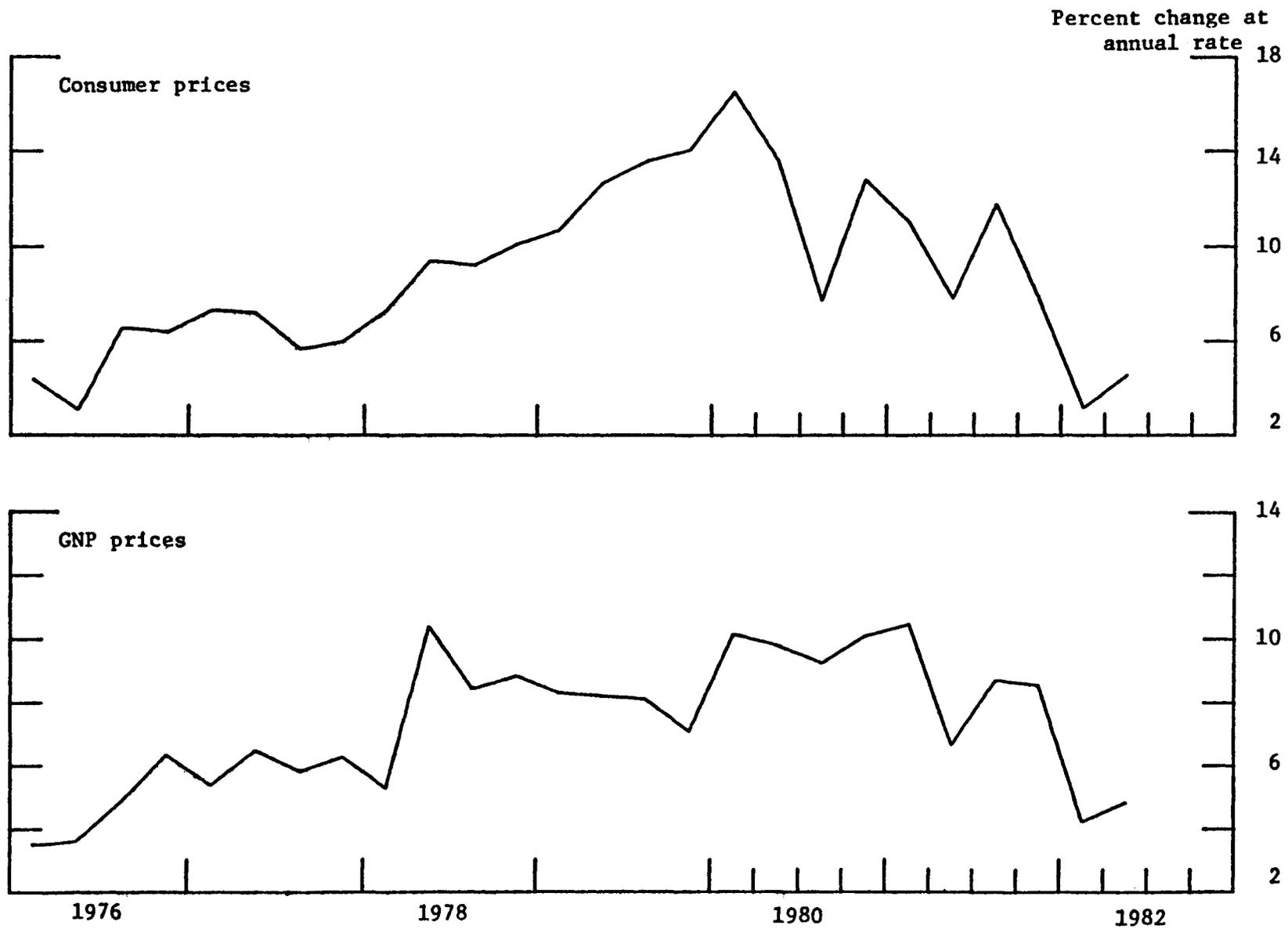


CHART 3

AVERAGE WAGE INCREASES HAVE MODERATED

