

An Emerging Game Plan for Price Stability

by

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presented at the

Pittsburgh Economics Club

Pittsburgh, Pennsylvania

February 17, 1981

It is a distinct honor for me to address the Pittsburgh Economics Club. This community has long been--and continues to be--recognized as one of the centerpieces of the industrial might of this nation. Our ability to preserve and enhance that economic might--not just here in the industrial heartland of America--but throughout the country--has, in recent years, fallen into some doubt. Indeed, while the past decade has not been without social and economic gains, there is a widespread recognition that our overall economic performance has not lived up to our expectations--expectations which had been framed over a long period during which we achieved reasonably steady gains in productivity and in our standards of living.

Against the backdrop of that earlier record of economic achievement, the frustrations associated with our more recent performance are not difficult to understand. And, in a manner, those frustrations can, and I believe are, serving as a catalyst that can help to bring about the changes in public policy and private actions that can put us back on the road to a pattern of economic performance compatible with our expectations and our earlier achievements.

You know as well as I that there is a myriad of forces that contributed to the slippage in our economic performance. But, and at the risk of an oversimplification, it seems to me that the central force in that deterioration can be found in the fact that we--for too long--deluded ourselves into thinking we could live with and even live better with a little more inflation. We convinced ourselves that we could somehow isolate or insulate, we

could somehow index or subsidize, we could somehow muddle through. We accepted that thinking because we also believed that the "little more" inflation seemed to buy so much more in terms of lower unemployment and increased availability of goods and services.

Unfortunately, we, like many before us, were wrong. Indeed, in retrospect it is now clear that had we been willing to look hard enough and had we not been willing to delude ourselves, we would have recognized that accelerating inflation is not something that can be lived with. There is no such thing as a "little more" inflation. Inflation is inherently debilitating, and as it grows, the resulting distortions and inequities grow with it. There is no escape--there is no haven.

Now, and to use an analogy well suited to this City, I sense there is a clear recognition that we need to change the game plan--that we need to alter our policies, our attitudes, and our actions in a coordinated and sustained effort to beat back inflation. That effort will test our mettle; it will produce cross-currents of debate and dialogue as to the best techniques; and it will produce its own temporary setbacks and disappointments. All of this notwithstanding--and I want to be very clear on this point--I strongly believe that we have the ability, the tools, and the opportunity to achieve that result. It will not be easy but it can be done, and it must be done, for if it is not done now it will have to be done later when the problems and the pain associated with the cure will be all the worse. To return to my analogy, if we don't change the game plan now, we probably will have to change the rules of the game later and change them in ways that could be in fundamental conflict with some of our basic values.

At this point in time, fiscal policy has assumed center stage as the new Administration and the new Congress grapple with the incredibly difficult task of tax and government spending policy against the legacy of 20 years of recurring and often large federal deficits. I cannot and will not speculate at this time as to how the specifics of that effort will evolve, but from my personal vantage point I believe there are several principles that should guide the exercise.

First, I think it is clear that expenditure cuts must be large by any historical standard, particularly in light of the upward pressures on the defense budget. Second, I believe that public and congressional support for budget cuts will be more readily forthcoming if the associated short-run burden is shared across industry and interest groups. My point, of course, is that unless these groups can compromise their narrow interests and unite behind a broad program of reductions in federal spending we will all be losers. Third, achieving expenditure reductions is, in my view, a necessary prerequisite for cutting taxes. There is no questioning the proposition that the tax burden on households and business have become stifling. Thus, the case for tax reduction is powerful, but so too, in my view, is the case that we must earn our tax reductions by spending restraint. That is why I believe that tax cuts should, in some fashion, be linked to the achievement of spending cuts, even though I fully recognize that the question of how to achieve that linkage is largely a tactical one.

I said earlier that the process of winding down inflation will not be easy, and I think it is fair to say that the difficulty

associated with the process will be illustrated early in the game as the Congress comes to grips with the expenditure cutting effort. However, I for one, have a sense that--earlier disappointments notwithstanding--we may in this current environment be able to achieve a real measure of success in this difficult but necessary task. In that spirit, I would hope that the leadership of the business community, so well represented in this room, will actively and enthusiastically support these efforts, even if some of the reductions have to come from programs that are seen as beneficial to your particular industry or your particular area of the country.

Of course monetary policy has an essential role to play in making this endeavor successful. The Federal Reserve has recognized this and has accepted the challenge of restraining the growth of money and credit over time to rates consistent with long-run price stability. Chairman Volcker will present the details of our policy objectives for the coming year to Congress next week, but I can assure you here and now that we in the Fed have absolutely no intention of reneging on our pledge to achieve continued restraint in money growth. That policy serves to underscore the need for the fiscal restraint I have spoken of earlier. It is, for example, a matter of simple arithmetic to see that if the Fed limits the creation of new money and the Treasury must finance large budget deficits in the capital markets, strong upward pressures on interest rates result, and in the process private borrowers, large and small, get pushed aside. We will not be able to escape from this situation in the short run. That is, even if the Administration and the Congress are highly successful in cutting expenditures,

much of the impact of their actions will not be felt until 1982 and beyond. In short, under the best of circumstances, the Treasury will have a significant presence in the credit markets in 1981.

I have said earlier that coordinated and sustained efforts on the part of monetary and fiscal policy can and will work to wind down inflation. However, the speed of the adjustment and the degree of discomfort associated with the process can be influenced by other aspects of public policy. For example, there is a widespread and legitimate recognition that lifting the burden of government regulation can and will assist in the effort. However, as we rethink the once conventional wisdom about the role of government, I believe that we must be prepared to look beyond expenditure restraint and deregulation, at least in the narrow sense of that word, and come to grips with other--more subtle ways--in which we have interposed the government into the economic arena.

For example, there are aspects of public policy that entail little or no cash disbursement but nevertheless have major implications for overall economic efficiency. Restrictive trade policies are a case in point. The enormous growth and proliferation of subsidized or government-guaranteed credit programs is another. The myriad of statutes that indiscriminately ratchet up wages and prices is still another. All of these programs--and others I have not mentioned--reflect an understandable--and sometimes legitimate effort--to use government policy to protect and insulate economic agents--large and small--from the risks necessarily associated with a vigorous and viable market economy. In short, we have put in place a massive federal safety net. That safety net, however com-

forting it may be, is a further impediment to restoring greater economic efficiency and winding down inflation. Stated differently, if through public policy we effectively eliminate downside risk, we must also be prepared to accept the fact that coping with inflation, low productivity, and stagnation in real income growth will be all the more difficult.

In saying this I do not mean to suggest for one minute that some elements of that safety net are not wholly desirable and appropriate. For example, deposit insurance makes imminent sense. However, by the same token proposals that would insure every dollar on deposit do not make sense because they would only work to weaken the discipline so necessary to an effective banking system. My point in using this example is merely to illustrate that the issue as to where the role of government should stop and where the unencumbered workings of the market should start is seldom a clear-cut choice. Precisely where the line is drawn may not, in fact, be as important as is our willingness to recognize in a philosophical manner that we simply cannot insulate against all risk of loss and expect that the economy will function at maximum effectiveness.

The challenges obviously are great, but the rewards for getting on with these difficult tasks will be far greater. Success will not come easily, and there will be obstacles along the way that can produce further frustrations and further doubt. For example, right now those of us responsible for monetary policy are grappling with the very messy problem of observed distortions in the growth rates of some of the monetary aggregates arising from the nationwide introduction of NOW accounts. Similarly, because of

some technical factors such as the earlier run-up in mortgage interest rates and because of some transitory factors including energy prices and payroll taxes, the price statistics in early 1981 may show some deterioration. Obviously we cannot fully ignore these types of developments, but at the same time we must be prepared to look beyond them and, above all, not permit them to undermine our confidence and our commitment.

In closing, allow me to make one final point. The thrust of my remarks today, quite naturally, has been directed at public policy. However, I know you recognize that private attitudes and private actions are equally important. Indeed, just as we need discipline and patience in our monetary and fiscal policies, that same discipline and patience is needed in the setting of wages and prices in the private sector. For example, I believe it is very important that business and labor avoid the temptation of seeking to fully recoup earlier perceived or real losses in wages and profits adjusted for inflation at the first signs of a resurgence of overall economic activity. Here, too, a little patience and a lot of discipline can go a long way toward insuring that we create the conditions necessary for sustained economic growth.

In short, the game plan for restoring price stability that I see emerging is one in which there are no spectators--only participants. We all have an enormous stake in its outcome, and we all must be prepared to contribute to the effort. Then, and only then, can we all be winners.