<u>The Fed in the 80's</u>

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The air is thick with gloom and doom these days--plus (with the debacle in the silver market) a premonition of disaster. As someone said recently, he felt like a Chrysler salesman on Three Mile Island.

The foreign exchange market, however, is behaving as though it's unaware of this. Last Dec.31 the dollar was worth 1.72 Deutschemarks and 240 Yen. Today the dollar is worth 1.96 Deutschemarks and 250 Yen--an appreciation of 14 and 4 percent. Of course, there are some special reasons for this, in the relationship of interest rates, but I sometimes wonder if foreigners don't see our economic picture more clearly than we do.

My message this evening is one of hope--qualified hope, to be sure, but yet hope that the 1980's will bring substantial improvement. From my viewpoint in the Fed, this prospect is most welcome. Having been on the front lines for so long, we in the Fed would be happy for some rest and recuperation. Whether the 1980's will provide that opportunity will depend on how vigorously we all tackle inflation right now.

I would like to talk about inflation, how to reduce it, prospects for success in the coming decade, and what all this means for the Fed.

A "new" inflation

The inflation we now have is different from any we have had before. If you go back a century and a half and trace the movement of prices, you will see a jagged line. Prices have gone up sharply during wars (the Revolution, 1812, Civil War, World War I and World War II). In every case except the last, prices have dropped back down again after the wars. Not after World War II, however. The line has taken off almost vertically, and for more than a decade and a half has not declined at all.

Reasons for this are complicated. In fact, I happen to believe that inflation is much more complicated--and therefore solutions to it also--than most people think. Let me list some of the causes.

Causes of inflation

You often hear people say the following--

- inflation is caused by OPEC, or
- inflation is caused by unions, or
- inflation is caused by Government deficits, or
- inflation is caused by regulations and taxes that impede the supply side of the economy, or
- inflation is caused by too much money chasing too few goods.

Therefore, these people say, the solution to inflation is to--

- develop an independent energy policy, or
- hold down wages, or
- hold down Government deficits, or
- stimulate the supply side of the economy, or
- keep the Fed from printing too much money.

I would say all of these people are wrong and right at the same time. They are wrong if they single out any one cause or solution; they are right if they say inflation is caused by all of these factors--at times some more than others--and must be solved by dealing with all of them.

Solutions to inflation

Energy. It is clear, first of all, that we need an energy policy that will make us less vulnerable to outside shocks like OPEC price increases. I don't profess to understand all the nuances of such a policy, but I do believe that the price system should be a major part of it. The idea of letting the price of oil and gasoline go up to reflect forces of supply and demand has been ridiculed by some as only adding to inflation. Of course it does--in the short run. But I do believe that a price that truly reflects market forces (and this means a higher price) can be more effective than anything else in cutting back demand and stimulating supply. In the longer run it is anti-inflationary.

Wages. Although wage increases have been surprisingly moderate, considering the inflation of consumer prices, they have been much greater than increases in productivity (which actually have been negative recently). When wages rise faster than productivity, they put pressure on businesses to raise prices still more. It is understandable, therefore, that part of the political debate these days is whether to put on wage and price controls. I happen to believe that controls wouldn't work, and I believe the record supports this view. But efforts to persuade labor to hold down wage demands have been partly successful and should continue as vigorously as possible. In the near term, wage settlements will be greater than they have been, but as inflation is brought down during the 80's, labor should not feel under so much pressure to demand such large increases.

Deficits. Government has run deficits for too long and in too large amounts. The 1970's were the first decade in our history without a single year of surplus. Good economic policy calls for at least a balance and preferably a surplus in times like these. Moreover, the public has become so skeptical about big Government and big-spending Government, that a demonstration of resolve is essential for psychological reasons. Although the economy undoubtedly will turn soft at times in the 80's (and most likely very soon), Government should not be quick to step up deficits to get the economy moving rapidly again.

The public's inflationary expectations can best be quenched by a fairly steady dose of fiscal conservatism for some time.

Supply. The latest fashion--supply-side economics--deserves attention. As I've already mentioned, productivity has been sadly lagging, and thus contributing to inflation. No one understands all the reasons behind the productivity problem, but certainly Government regulations and tax policy are a factor. True, some of our economic product is now taking the form of cleaner air and water and other such gains not measured by GNP. So in this sense productivity may really be greater than we think. And to the extent that these gains have been fostered by Government regulations, society has gained. But it is also undoubtedly true that many regulations have hampered the ability of business to produce and have raised the costs of producing. In this sense, streamlining of regulations can help to reduce inflation. On the tax side, attention must be given to providing incentives to invest in research and new productive facilities so as to enable business to turn out more products at lower cost. These approaches to supply should be a major part of policy in the 80's.

Money. If all of these things can be done, there will be less need for the Federal Reserve to keep money tight and interest rates high in the 80's. As things now stand, few of these things are being done and so the Fed is virtually alone in the inflation fight. We have been successful, but only partly so. The rate of growth of money is being slowed and credit is much harder and more expensive to get. The policies put in place last October 6, were working and in time would have had a substantial effect on the economy and inflation. But time was running out and the policy was not hitting some parts of the credit market hard enough. Hence the new policy announced on March 14. By striking directly at consumer and business credit and money market mutual funds, these controls will, I believe, bring the desired result more quickly. But these are a last resort and a temporary necessity. I would be very discouraged, indeed, if at the end of the decade we were to look back and see these kinds of controls in frequent use. More fundamentally, we in the Fed need to be careful not to run the printing press too rapidly. We have generated too much money in the past and for some time to come we need to bring money growth down to more normal levels.

Prospects.

I have hope for the 80's. The first part of the battle is behind us: we as a society know what our problem is. I can't remember a time since World War II when the country has been so agreed on a common objective. We disagree on how to accomplish it, but these disagreements aren't insuperable. Moreover, some things will be working for us in the 80's. Population trends, for example, should help to increase productivity and reduce inflation.

So I have hopes that the high rate of inflation that produces so much gloom and doom today will give way to a lower rate as the 80's proceed. With that can come lower interest rates. Realism suggests that by the end of the decade we may well find ourselves with more inflation and higher interest rates than we would have thought tolerable only a few years ago. But our sights are different now. If this scenario comes to pass, I would expect our position in the international economy to benefit. The current state of the dollar probably can't last forever, given the likelihood that the relationship between our interest rates and those of our trading partners will change. Also, I expect the dollar will be in for tough times occasionally as we move through the decade. But action on the fundamentals here at home can do much to safeguard our position in international markets.

The vital point I want to leave with you is that the economy in this decade will hinge on what we all do in the early 80's. If we boot it, the decade could be miserable indeed. If we persevere in the next few years, expectations can change, confidence can be restored and we can all move ahead to new challenges. Speaking selfishly, it would be nice if we in the Fed could be able to relax a little bit and enjoy the economy. I suspect some others wouldn't mind, either.