

Remarks

by

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I am pleased to return to Providence to share this afternoon with such distinguished colleagues who will add a great deal to ~~the~~ **brief** outline I will present. Our subject is monetary policy in a **changing** world. It seems to me to be absolutely true that in the post-war era we've been experiencing a period of rapid and accelerating change. There have been changes in almost everything we do or deal with. There have been great demographic changes. Extension of life through modern medicine has meant more older people in our society, and the baby boom following World War II has meant more younger people, so that we have a different mix in population that in turn influences our economic and social environment. We have also seen tremendous social changes as we've continued to move from an agrarian society, to an industrial society, to a more urban, metropolitan society. This has caused great changes in the structure of families, in their relationship to work, and in their life experiences.

We've also had tremendous political change since World War II: new nations created, evolving, trying to find a new world order to deal with new political realities. We have a growth in the number of socialist states; we have less developed countries that feel they have a claim to a portion of world progress.

We've seen tremendous economic changes as we've moved from a world of independence to tremendous interdependence. And, of course, there has been great technological change. As I mentioned, we have moved from an agrarian society to an industrial society, to a technological society. We've substituted machines for muscle power in order to achieve a higher standard of living. But recently we've run into the finite limitations

of what we thought were infinitely available energy resources, and that has strained the opportunity for further progress. That brief chronicle will perhaps, at least make the point that we do live in a world of rapid and important changes.

The 1970's have been characterized by a series of shocks. They have thrown our system into imbalance; they have caught us off guard. But the inherent strength of our American system has been demonstrated by our ability to absorb these shocks and continue to make as much progress and as we have to enjoy prosperity as we now do. We've demonstrated that our system has great resilience. It has the capacity to absorb these changes. But now we are going to be tested as to whether we have the will and the skill to correct the fundamental imbalances and avoid the insurmountable problems that are inevitable unless we attack the fundamental issues.

Let me summarize some of the shocks and discontinuities that have characterized the past dozen years. The war in Viet Nam was divisive. The state of domestic tranquility was interrupted by civil disorders. Failure to pay for that war planted the seeds of inflation. The threat of inflation lead to imposition of wage and price controls which proved to be unworkable, inequitable and ineffective. The international monetary system broke down. With wage and price controls holding down the lid, the U.S. economy was reflatated and allowed to build up a high pressured head of steam. When the controls were lifted, the steam blew off, producing double digit inflation and double digit interest rates.

To compound the difficulties, the oil boycott ushered in a five-fold increase in world petroleum prices. Then the Watergate incident and its aftermath led to a general public disaffection with all institutions,

public and private. And finally, there was the great recession of '74-'75 with 9 per cent unemployment and the greatest economic distress since the depression of the 1930's. As an aftermath of these shocks, **inflation is** now our most serious domestic problem.

Inflation destroys values and incomes, it dries up job-creating investments, it impairs the prospect for new housing and other construction, and it breeds recessions. It creates financial strains for individuals, businesses and governments, accelerates government spending, causes higher interest rates, and disrupts international trade and the stability of the dollar. It is especially hard on the poor, the elderly, and those who live on fixed incomes. In short, inflation is the most disruptive force in our economy today. It is the cruelest tax of all.

Perhaps the best way to illustrate the clear and present danger of inflation is to consider the consequences over a normal working life of forty years or so of the present experience of inflation. If the inflation that now exists in the United States were allowed to continue at its present rate over a normal working lifetime, then when young Americans today reach retirement age they will have a dollar that is worth less than a dime. The dollar held by today's young adults will be worth less than ten cents when they reach age 65.

The international value of the dollar is also related to inflation. The decline of the dollar in the past year can be traced to the record U.S. trade and current account deficits and to the level and persistence of U.S. inflation rates. The decline of the dollar itself adds to inflationary pressures as the goods we purchase from abroad cost more and the competitive constraints on domestic producers are reduced.

The decline of the dollar in the last year has added over one per cent to the inflation rate this year, and that alone is equivalent to more than a \$20 billion tax on all Americans. Obviously, we have an obligation to the world to have a sound dollar. In our own self-interest, we need a stable dollar to avoid disruptions in our patterns of international trade and to dampen the inflationary pressures at home.

One additional important factor in all these considerations is energy. America was fortunate to be able to develop as a nation by utilizing the seemingly boundless resources of a vast, almost unpopulated, continent. The availability of abundant and inexpensive energy fueled the growth of a great industrial society. But with 6 per cent of the world's population consuming 30 per cent of its energy, it was inevitable that the day of reckoning would come. The forces of supply and demand came into play with a vengeance. In 1973, the United States paid about \$8-1/2 billion for imported oil products. This year the import bill for oil will be over \$40 billion. This enormous shift contributed to the large U.S. trade deficit and the pressure on the dollar. The task ahead is to convert our industrial, commercial, residential, transportation and public infrastructures into more energy-efficient systems. We need to conserve present energy reserves, to reduce dependence on foreign petroleum, and to change over to alternate, more economic energy sources. This process will certainly take a decade or longer.

Given all these changes and the present circumstances, what is the role of monetary policy in combating inflation?

First, let me make a couple of observations on the limits of what monetary policy can achieve. In my opinion, monetary policy cannot do the job alone. Nor is there an automatic pilot to guide monetary

policy. It is just not possible to solve our problems by setting a dial for monetary policy and going home. If monetary policy is left to do the job alone, the consequences are very unattractive. If the Federal Reserve, as the central bank, should be left alone to restrain inflation by tightening up the money supply, that tightening would inevitably have to go so far as to bring on an unwelcome recession that would not solve the fundamental problem. But should the Federal Reserve accommodate inflation by making money available to validate it, then inflation would accelerate to double digit levels and we would be headed for a delayed, but much more severe, economic decline -- a decline which would be very disastrous to our national goals and to our individual and collective well-being.

Nor can monetary policy be set on automatic pilot without serious danger. If oil prices increased four-fold, an effort to hold money at a predetermined level would restrain the ability to pay for that oil and the economic aftermath would be very disastrous. Nor can a fixed monetary policy deal with the crop failures in India or Brazil or the Soviet Union which limit the availability of food supplies. Nor can monetary policy deal with Federal deficits that escalate in the face of declining economic activity. Over the last five years, the federal deficit totaled to more than \$300 billion; withdrawing that much out of our economy through monetary policy would bring very severe consequences.

What, then, is the current objective for monetary policy?

Since March 8, when I was sworn into office, we have had a series of objectives for monetary policy. One is to recognize the clear and present danger of inflation and to exercise restraint, endeavoring to bring about a lower growth in the rate of money supply and a lower growth in the real

growth rate of the economy. On March 8, the projection was for the U.S. economy to grow during this calendar year at a real rate of about 4-3/4 per cent. It now appears that this year the economy will grow at about 3-3/4 per cent -- a significant decline in the growth rate as part of the effort to restrain inflationary forces.

Second, we have endeavored to exercise monetary policy so as to slow the growth rate on a smooth basis, so as to avoid the shocks and disruptions and swings that have characterized our economic policies for the last dozen years. In my opinion, this policy increases the prospect for reducing inflation without tripping us into recession.

A third objective has been to restrain the economy while maintaining balance and avoiding too great a burden falling on any one sector. An example was our decision, in the spring, to authorize new kinds of savings instruments so that we would avoid the disintermediation that created a depression in the housing industry in '74-'75. So far, this new policy has been working, with flows of funds to thrift institutions that housing continuing while the whole economy was restrained.

We can, at this moment, be somewhat pleased with the results. The economy is in remarkable balance. Consumer spending continues, but at a lower pace, more consistent with the growth of personal income. Inventories held by businesses are in excellent balance. Business fixed investment has not bubbled up to a point where it would be expected to decline suddenly. Our position in housing has been maintained. And throughout the economy, generally with few exceptions, there is the ability to continue to progress at the current rate without any shortages or bottlenecks.

A fourth objective has been to coordinate monetary policy with other economic policies so as to curb inflation without triggering a recession. In March, the plan for the fiscal year which began to the Federal government on October 1 -- FY 79 -- was for spending and taxing that would result in a federal deficit of \$60.5 billion -- a rising deficit when we would be entering the fourth and fifth years of economic expansion. In seven months, that plan has been changed. Today, we are looking at a planned deficit of only \$38 billion -- a \$22 billion change in fiscal policy in a few short months. I cannot find any time in history when the U.S. changed a fiscal plan already submitted by the President by anything like this amount. While we can and do argue that more needs to be done, at least the trend is encouraging.

A fifth aspect of monetary policy has been to look for and get temporary help from other policies, including the President's deceleration program, so that we could gain the time for monetary and fiscal disciplines to have an effect as they work with a lag through the economy.

All of these are short-term approaches to dealing with inflation, and they are only the prologue. Inflation has built up for too long and has become increasingly structural for us to believe that we can control it in three months, six months, or a year. It will take considerable time to eradicate this virulent disease. We must be willing to commit ourselves to an anti-inflation fight of five to seven years if we are to succeed in returning to price stability on a permanent basis.

Let me suggest some of the longer range policies we must pursue if we are to succeed in the long run.

First, we must move progressively to a balanced federal budget with full employment. Now that we have reversed the trend of an escalating federal deficit, we must continue our efforts. FY 1980 offers the opportunity for further fiscal discipline to bring the deficit below \$30 billion and, by 1981 or 1982, to balance the budget. This is essential if we are to take the pressure off of monetary policy and create a more balanced coordination of policies to deal with this very serious difficulty.

Second, it is imperative that we reduce the federal government's role in our economy. Government has grown too big. The Federal government alone represents over 22 per cent of our gross national product. A program to reduce the role of the Federal government over five to seven years is essential to our long-term success. What is needed is to bring it down gradually, avoiding shocks and disruptions in the economy, so that within five or six years the Federal government will represent only 20 per cent of our gross national product. This means a slower rate of growth in federal spending -- not immediate reduction, but a rate of growth slower than the rate of growth of the economy. It also means that in several years some \$75 billion could be shifted from the public sector to the private sector where the individual decisions of people and businesses would be far more efficient.

A third important long-term element is to expand our capital investment. For a long time the United States has been a leader in technology and in production, but we are falling behind rapidly. Germany spends 15 per cent of its GNP to improve its capital base; Japan, over 20

per cent. We have been spending 8 to 9 per cent. Over a dozen years such a lag accumulates to place us in a very poor competitive position. It is essential that the United States create the incentives for business investment that will bring us to a level of 12 per cent of GNP. We need modernization, expansion of our productive capacity, lowering of the unit cost of production, improvement in the energy efficiency of our production, and improvement in our competitive position in the world so that we can re-establish our technical and technological superiority.

A fourth important plank in the program is to promote exports. As we transform our own production and transportation stocks to energy efficient systems, we will be dependent upon large supplies of imported petroleum. The best way to offset that requirement -- until we build up indigenous sources of energy -- is to expand our exports. As a nation, we have not been oriented to exports; we have not even tried very hard to export. Currently, we export about 6-1/2 per cent of our GNP. We should have a goal -- over the next five, six or seven years, -- of building our exports to ten per cent of GNP.

A fifth element is a sound energy program, which would provide the basis for conserving our existing energy and for shifting to more economical and indigenous sources.

A sixth element is regulatory reform to remove the burden of regulations on our economy without compromising our social objectives. Much of our regulation is not cost-effective. Much of it involves a burden that is not proportionate to the public benefit. We need a far more dedicated effort in regulatory reform.

Seventh, we must continue monetary discipline, despite the temptations that may present themselves, so that we maintain a continuing responsible program to reduce the rate of growth of the money supply until we have squeezed inflation out of the economy.

Finally, all of our efforts must add up a a concerted effort to reduce inflation at a reasonable rate. It is not possible to eliminate inflation in six months or a year, but it is possible, if we pursue all of the programs I mentioned, to set as our target a reduction in inflation of $1/2$ or $3/4$ of one per cent per year until we return to full price stability.

This is a difficult task. It will test our will, our determination, our patience, our persistence, our constancy. It will test our skills, but it is the only and best choice we have for achieving the economic goals we all desire: full employment, price stability, and a sound dollar. We can achieve those goals and, when we do, we will have created the best prospect for peace and prosperity throughout the world.