NEW DIRECTIONS IN ECONOMIC POLICY

Remarks by

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I am pleased to join this distinguished group to discuss adaptation of economic policy to a changing economic environment. In the post-World War II era we have experienced a period of rapid change. There have been changes in almost every aspect of our Nation and our economy. There have been massive demographic changes. Extension of life through modern medicine has meant more older people in our society, while the baby boom following World War II meant more younger people. Thus, we have had to contend with a dramatically different mix in population that has had diverse influences on our economic and social environment. Tremendous social changes have occurred as we moved from a partly agrarian, partly industrial society, to a more urban, service-oriented society. The structure of families, their relationship to work, and their life experience have been greatly modified.

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 and economic realities. Our own economy has moved from a world of comparative economic independence to substantial interdependence. And, of course, there has been great technological change. We've substituted machines for muscle power in order to achieve a higher standard of living.

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 as we have and to enjoy as much prosperity as we now do. We've demonstrated that our system has great resilience. It has the capacity to absorb these shocks and adapt to a changing world. But now we are going to be tested as to whether we have the will and the skill to correct some continuing fundamental imbalances.

Shocks to our Economy

Let me summarize some of the shocks and discontinuities that have characterized the past dozen years. The war in Viet Nam was socially and politically divisive. Economically, 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. Almost simultaneously, worldwide crop failures and the OPEC oil price increases drove up prices of staples. Yet, with wage and price controls holding down the lid, the U.S. economy was reflated 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. And finally, there was the recession of 1974-1975, with its attendant 9 per cent unemployment and continued rapid inflation. Today, as an aftermath of these shocks, inflation is our most serious domestic problem.

The Costs of Inflation

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.

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 nearly 1 per cent to the price level this year, and that alone is equivalent to a consumption tax of $10 to $15 billion on all Americans. Clearly, we need a stable dollar to avoid disruptions in our patterns of international trade and to dampen the inflationary pressures at home.

Adjusting to Expensive Energy

The cost and availability of energy is a crucial factor in today's realities and tomorrow's answers. America was fortunate to be able to develop as a Nation by utilizing the seemingly boundless resources of a vast, almost unpopulated, continent. Abundant and inexpensive energy fueled the growth of our great industrial Nation. 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 and products will be more than $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, and will require support and extension of the President's energy policy.

Given all these changes and the present circumstances, what is the appropriate role of economic policy in combating inflation in the near term and restoring noninflationary, high employment economic growth in the long run?

Limits on Monetary Policy

First, let me make a couple of observations on the limits of what monetary policy can achieve. Monetary policy alone cannot solve the Nation's economic problems. If monetary policy were required to do the job alone, the consequences would be very unattractive. On the one hand, restraining inflation by tightening up the money supply without supporting actions in other areas would inevitably have to go so far as to bring on an unwelcome recession that would not solve the fundamental problem. On the other hand, if we were to accommodate inflation by making money available to validate it, then inflation could accelerate to double-digit levels, and we very likely 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 fixed monetary policy deal with Federal deficits that escalate in the face of declining economic activity. Over the last five years, the Federal deficit totaled more than $300 billion, a heavy burden on financial markets.

Objectives of Monetary Policy

What then, is the current objective for monetary policy? Since March 8, when I was sworn into office, we have had several objectives for monetary policy. One objective has been 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 more moderate rate of expansion of the economy. On March 8, the U.S. economy was expected to grow at a real rate of about 4-3/4 per cent during this calendar year. It now appears that the economy will grow at about 3-3/4 per cent this year--a significant decline in the growth rate.

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, success in this objective would greatly increase 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 for depositary institutions so that we would avoid the disintermediation that created a depression in the housing industry in 1974-1975. So far, this new policy has been working, with flows of funds to thrift institutions well maintained.

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 generally are in balance relative to sales. 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 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 on October 1--FY 1979--was for spending and taxing that would result in a Federal deficit of around $60 billion--a rising deficit during the remainder of the fourth year and into the fifth year of economic expansion. In eight months, that plan has dramatically changed. Today, we are looking at a planned deficit of only $39 billion--a $21 billion change in fiscal policy in a few short months. I cannot find any time in history when a fiscal plan already submitted by the President was modified by anything like this amount. While we can and do argue that more fiscal prudence is needed, at least the trend is encouraging.

Policy Goals for the Long Haul

These, of course, are near-term approaches to dealing with inflation, and they represent only the opening skirmish. The forces of inflation, have built up over a longer period and it will take many years to wring inflation out. It depends not on our treating the symptoms, but on our curing the fundamental causes.

Fiscal Prudence is Required

First, success requires exercise of continued fiscal discipline over 5-7 years. It will test our will, our determination, our skill, and our economic and our political systems. The President has committed himself to fiscal discipline, and to a policy of reducing Federal expenditures and reducing Federal deficits. It is now possible to see us on course toward a balanced budget by FY 1981--certainly by FY 1982.

Pursuing this course will reduce the relative role of the Federal government in our economy. Federal expenditures should be reduced from the current level--some 22 per cent of gross national product to something like 20 per cent. By FY 1983 this would release $65 to $70 billion annually back into the private sector where the cumulative effect of decisions of individuals and businesses will be far more effective in our economy. So, fiscal policy is now on a course of new discipline, new restraint; that is a change in direction since the beginning of this year.

Cooperation with Anti-Inflation Guidelines

A second weapon is an incomes policies--wage and price moderation through voluntary efforts. The President made his first initiative on an incomes policy on April 11, when he called on the private sector to cooperate in a program of deceleration. Late last month, he called for a broader-based, more-specific program of restraint and moderation in wage and price actions, establishing a series of standards consistent with other policies to be introduced, and seeking cooperation in adhering to these standards.

This, of course, is the area where your cooperation, individually and collectively, is so important. It seems to me that it is reasonable, in a time when there is such urgent need for unified national action on a critical problem, that we all make the sacrifice and create the will to bind ourselves together, to commit ourselves to this program.

If the speed limit in the United States was defined simply as "reasonable speed," I'm sure that with today's well-engineered automobiles most of us would drive 80 miles per hour. But because we want to conserve energy and conserve lives, we set a speed limit of 55 miles per hour and we actually drive close to 55 miles per hour. Similarly, the President has set up some standards, and it seems reasonable to me that, with cooperation of business and labor unions, we can adhere to those standards while we buy the time for fiscal, monetary, and other policies to have their effect. This gives us the running room to make the changes in our economy that are essential if we are to eradicate inflation.

Regulatory Reform

A third policy has to do with reduction of the regulatory burden. I will not dwell on this topic. It is a difficult task, one that may require some redirection through legislation as well as through administrative action. While it is essential that we move with great force and determination in this area, it would be unrealistic to expect immediate results in its effects upon inflation.

Stimulate Productivity Growth

The fourth issue on our long-range policy agenda is a restoration of brisk productivity growth. During the first twenty years after World War II, productivity gains in the private economy averaged 3-1/3 per cent per year. With productivity gains at that level, it was possible for the United States to achieve annual increases in real income for all Americans. But for the past ten years, we have fallen behind. From 1967 to 1972, our productivity gains slipped to a 2 per cent a year average, a poor performance. Since then, they have been even worse. Over the last five years, productivity gains in this country averaged only 1-1/3 per cent, contributing substantially to the process by which inflation becomes embedded in our system and making it more and more difficult for us to break the cycle of wages chasing prices and prices chasing wages. It is therefore essential that the government, with your cooperation, direct its policies toward initiatives that will revitalize business fixed investment. It is the only way I know to achieve the productivity gains that were typical for the first 20 of the last 30 years.

For some time now we have been falling woefully behind the other industrial nations in replenishing our capital stock. The Japanese spend more than 20 per cent of their gross national product on fixed investment, on the replenishment of plant and equipment and on modernization and new capacity; the Germans, 15 per cent. In the United States, only 10 per cent or so of the gross national product has been going into capital investment. It is essential that we raise this to at least 12 per cent over a sustained period so we can contribute to more energy efficient production, become more competitive in world markets, stem inflation, renew our technology, and once again become the dominant industrial nation of the world.

Expand our Exports

Fifth, we need to address ourselves to balancing our international accounts. It is the combination of our trade and current account deficits and higher rates of inflation that has driven the dollar down to such low levels within the past year.

Paralleling the energy program I mentioned earlier, we need to launch a continuing and increasingly effective promotion of exports. While we strive to reduce our dependence on foreign petroleum, we must also strive to increase our exports to fill the payments gap. We have not been an exporting nation by history or by interest. Once we make up our minds that this is important, we can achieve a great deal. It is essential that we now make a complete commitment to an effective export effort so that we can build our exports up to 10 per cent of GNP in line with the secular growth of imports. In this way, we can help close the gap.

Cooperation of Monetary Policy

Finally, we need a continuing responsible monetary policy. Late last month, the President committed himself to a balanced, concerted and sustained program to fight inflation. Each of those words are important. There is no short, simple, sweet answer. It is going to take a balanced program involving all of these new initiatives. It is going to take concentrated and concerted effort. It is going to take staying power, ability to sustain our effort over years without tiring, without weakening, without losing confidence or faith. And this is going to test all of us.

From a monetary point of view, we must take the necessary medicine to cure the disease of inflation now, so that we can avoid more serious maladies later. It is important that we all understand that there can be no delay, no procrastination, no easy way out. We're going to have to face some difficult months and some difficult quarters, and some difficult years, if we are to constrain the forces of inflation and avoid greater difficulties, greater dislocations, and greater hardships later.

I know that many people in America assume that this is all the government's problem; the government is the cause of inflation; the government is the medium to cure inflation. Well, the government is a key factor; it has certainly done many things over the years that have built up the problem. It is also true that the government must provide the leadership. But it is undeniably true that this nation cannot accomplish anything without the cooperation and participation of the private sector.

To paraphrase from Pogo I would say, "I have met the government, and he is us." If there is any culprit in the government, then it is up to us to influence that government, to guide that government, to persuade that government, to cooperate with that government, to enter into a partnership with that government, so that the total force of this nation deals with this urgent crisis.