New Directions in U.S. Economic Policy

Address by

G. William Miller

Chairman

Board of Governors of the Federal Reserve System

Atlantic Bridge

Frankfurt

December 12, 1978

Mr. Chairman, members of Atlantic Bridge, ladies and gentlemen. I greatly appreciate the invitation extended by Dr. Karl Klasen for me to be with you on this occasion. It is a privilege and a pleasure for me to have the opportunity to address such a distinguished audience, dedicated as it is to fostering better understanding and friendship between Germans and Americans. In a world that has seen an explosion of information, there is a critical need for an explosion of understanding. Your goal, then, is particularly important, relevant and timely, and worthy of the best efforts of all people on both ends of the Atlantic Bridge.

Our countries share a common interest in a stable international economic and financial environment, without which no country will be able to prosper for long. With the growing interdependence among nations, international cooperation, built on a foundation of understanding and trust, is essential to such stability.

There is continuing close cooperation between the United States and the Federal Republic. It is especially close between the Bundesbank and the Federal Reserve. I am grateful to Dr. Emminger and his colleagues for making this possible. The fact of this cooperation and the powerful results that it can achieve were vividly demonstrated on November 1 when new initiatives were undertaken to correct the excessive depreciation of the dollar. Joint action by the U.S. Treasury and Federal Reserve, in coordination with German, Swiss and Japanese authorities, has brought considerable improvement of conditions in foreign exchange markets.

New priority to control inflation

It was nine months ago, on March 8, that I assumed my new position as Chairman of the Federal Reserve. At that time, U.S. economic policy was still concerned with recovery from the deep recession of 1974-75. In the intervening period, U.S. policy has moved in new directions to deal with the clear and present danger of inflation.

The principal objectives of current U.S. policy are well defined and universally accepted: to control inflation and to assure a stable dollar.

The acceleration of consumer prices in 1978 over the level of 1977 has emphasized the difficulty of controlling inflation. Nevertheless, we are determined to succeed, and we will persist in strong anti-inflation policies until the war is finally won. President Carter has made the campaign against inflation his number one priority. The American people overwhelmingly endorse this commitment, and the new Congress they have elected will reflect this attitude.

Background of current inflation

Inflationary forces within the U.S. economy have been building up over the past dozen years. The seeds of inflation were planted in the late 1960s when large government deficits were maintained at a time of very high demand. When inflation persisted through the economic slowdown of 1970, direct wage and price controls were imposed. They proved to be both inequitable and ineffective. With controls holding down the lid, the U.S. economy was stimulated, building up a head of steam in the kettle. Later when the lid

of wage and price controls was removed, the steam blew off in the form of explosive inflation. During the same period the fixed exchange rate system broke down. The entire industrial world experienced a simultaneous boom creating shortages of many industrial commodities. Agricultural reserves were exhausted through a combination of higher demand and poor harvests. Following the boycott, oil prices increased five-fold. The result of this sequence of events was double-digit inflation in the United States and in many other countries.

These shocks were followed by recession around the world. The recession was especially severe in the United States, but recovery was also strong. The rate of inflation slowed somewhat in the United States as commodity prices tumbled, but looking back, the underlying rate of inflation declined only a little. It began to increase again as the recovery proceeded into the current year with greater utilization of productive resources.

Arsenal to fight inflation

In the face of this resurging and virulent inflation, the United States has moved progressively to mobilize a full arsenal of weapons to carry on the war. Let me outline some of the components of this arsenal: first, fiscal policy; second, incomes policy; third, reduction in regulatory burden; fourth, revitalization of productivity; fifth, a balance in our international accounts; and sixth, a monetary policy which complements and supports the other elements.

Fiscal discipline

In the case of fiscal policy, there has been a major shift toward tighter control over federal spending and a corresponding reduction of deficits. The original federal government financial plan for fiscal year 1979 --which began on October 1--was modified to reduce spending and to cut back on proposed tax reductions so as to shrink the projected deficit by $22 billion. The President and the Congress demonstrated their resolve to fight inflation by taking this unprecedented, but highly commendable, action. As a result, the federal deficit will drop from about $49 billion in fiscal year 1978 to $38 billion in fiscal year 1979. President Carter has announced his intention further to reduce the figure to $30 billion or less in fiscal year 1980, even though this will mean a substantial cut in current service levels.

When the present surplus of state and local governments is taken into account, the governmental sector is no longer providing stimulus to the U.S. economy. And the stage is now set for a balanced federal budget as early as fiscal year 1981, but in any case by fiscal year 1982.

This application of increased fiscal restraint has a further goal: to reduce the relative role of government in the American economy. The emerging pattern means that federal government expenditures will steadily decrease from the present 22 per cent of gross national product to the 20 per cent range. Potentially, this will release $60 to $70 billion to the private

sector, where the cumulative effect of spending and investment decisions by individuals and businesses will have a more beneficial impact on economic progress.

Wage-price restraint

A second weapon in the fight against inflation is an incomes policy. On October 24, the President introduced a broad-based program calling for voluntary moderation in wage and price actions, establishing specific standards for wages and prices, and offering a series of incentives for compliance.

There is no intention of re-introducing mandatory controls, which have proved to be inequitable and ineffective. But there is a basis for seeking the cooperation of both management and labor to accept mutual restraint in their own self interest as a contribution toward curbing inflation and thus enhancing prospects for real gains in compensation and profits. The American system of labor agreements mainly involves individual company-union negotiations at random times, and the tradition is for three year contracts. With a heavy negotiating calendar coming up in 1979, involving about four million workers, it is important to find a formula for accommodation. One of the innovative aspects proposed by the President is a form of real wage insurance through the tax system to offset some of the uncertainty for employees who comply with the pay standards.

It took some weeks for the program to be communicated and explained, and some clarifications still will be required to deal with individual circumstances.

Yet, there is a growing acceptance of the concept, and many leading corporations -- including General Motors and American Telephone and Telegraph -- have pledged to comply. Officials of major unions have also been consulting with the Council on Wage and Price Stability on the details of regulations, particularly as applied to treatment of costs for existing fringe benefits, and this is an encouraging indication of their desire to find a workable arrangement that would permit compliance.

There are promising prospects, therefore, for the President's program in this area to help in breaking the cycle of wages chasing prices and prices chasing wages.

Reducing regulatory burdens

A third policy concerns the reduction of regulatory burdens which have added to costs, and thus to prices, without commensurate public benefits. Unwinding unnecessary regulatory burdens will take time, and may require some redirection through legislation as well as administrative action. While the short term effects on reducing inflation may be moderate, it is critical in the long term to unleash the American enterprise system from unneeded and costly restraints on its flexibility, responsiveness and creative capacities. The Administration has indicated its dedication to this objective.

Revitalizing productivity

The fourth component is directed toward revitalizing productivity. During the first twenty years after World War II productivity gains in the United States were the highest in the world, running about 3-1/3 per cent per year. This helped counter inflationary pressures even while Americans were achieving annual increases in real incomes. But for the past ten years we have fallen behind and productivity gains have been less than 2 per cent a year.

One of the principal reasons is that the United States has seriously lagged behind other industrial nations in replenishing its capital stock. This has been recognized and affirmative steps are being and will be taken to improve the climate and the incentives for business fixed investment.

The tax legislation passed by the last Congress included provisions to liberalize the investment tax credit and to promote capital formation. Additional measures, including reduction in regulatory constraints, can be expected. At the same time, we will increasingly benefit as the record number of new workers who entered the employment ranks over the past two years gains skills and experience. These two factors -- support the capital spending and a more experienced work force -- will help increase productivity and reduce unit costs. This, too, will play a role in breaking the vicious wage-price spiral.

International accounts and the dollar

Fifth has been the marshalling of policies and resources to deal with the international situation. The decline of the dollar in foreign exchange markets over the past year is clearly linked to the U.S. inflation problem and to our current account deficit. And the decline of the dollar has, at the same time, been one of the causes of rising inflation in the United States as essential imports have cost more and competition of imports with domestically produced goods has been reduced. The reverse is true in Germany, of course.

Energy aspects

One of the contributing factors to our trade deficit, and hence to our current account deficit, has been U.S. requirements for imported oil. The problem has its origins in history. For a long time, America was a vast, sparsely populated continent with seemingly inexhaustible supplies of inexpensive energy. A great industrial nation was built in part by taking advantage of cheap energy, sometimes in substitution for capital or labor.

But in time, with ever increasing demand, the limitation of supplies became a reality. Now, the United States will be engaged for a number of years in converting its industrial facilities, transportation equipment, housing stock and commercial establishments to be more energy efficient, in line with other industrial nations which have not had local supplies of cheap energy.

And the United States will be shifting increasingly to alternative sources of indigenous fuel.

Because the United States is a heterogeneous nation with many regional differences, as between energy producing and consuming areas, it has been particularly difficult to hammer out national energy policies. Important progress was made through the energy legislation enacted by the 95th Congress, which deals, among other things, with conservation, conversion to coal, and natural gas. The new natural gas law creates a single, national market where previously there were two markets -- the higher priced intrastate market, with a surplus, and the regulated, lower priced interstate market, with short or uncertain supplies, particularly for industrial users. The immediate consequence is that there are now abundant, indeed surplus, supplies nationally, which will immediately reduce the requirements for alternative imported oil and liquid natural gas. The Administration is now considering alternatives for moving domestic oil prices to world levels in line with the President's discussions at the economic summit.

Export promotion

Parallel with progress on the energy front, initial steps have been taken to promote U.S. exports. This effort is in its early stages, but increased emphasis can be expected as the other policy initiatives begin to take hold.

November 1 program

I have commented on the factors that influenced the decline of the dollar over the past year. But by late October, the lower exchange value of the dollar could not be explained by fundamental developments such as inflation and current account positions. In view of this circumstance, and of the importance of the dollar as a world currency, the Administration and the Federal Reserve, in cooperation with the Governments and central banks of Germany, Switzerland and Japan, decided to act forcefully to correct the excessive depreciation of the dollar. The measures announced on November 1 included a substantial increase in foreign currency resources immediately available for U.S. intervention in exchange markets, expanded gold sales, and a further sharp tightening of U.S. monetary policy.

The monetary action included a one per cent increase in the discount rate -- the largest increase since a similar move during the bank crisis in the early 1930's -- an increase in the federal funds rate, and a 2 per cent increase in reserve requirements on large certificates of deposit.

The marshalling of foreign currency resources for intervention on the U.S. side -- in addition to direct intervention by other countries' central banks -- involved an initial total of $30 billion in Deutsche Marks, Swiss francs and Japanese yen through Federal Reserve swaps, U.S. Treasury drawings on the International Monetary Fund and sale of Special Drawing Rights, and a U.S. Treasury program for sale of foreign currency denominated obligations. The

sale of foreign currency obligations represents an historic step for the United States and opens a new opportunity for acquiring foreign currencies without expanding the money supplies of other nations. The first U.S. obligations in DM are now being offered, with the subscription books to be closed tomorrow.

A vigorous application of the November 1 measures brought about a quick turnaround for the dollar. Within a few days the dollar has climbed sharply against all three of the other currencies. This was followed by a period of relatively stable conditions. But in recent days, with international events and some uncertainties in anticipation of the new European Monetary System, the market has been unsettled and the dollar has moved a bit lower. In my opinion, the reaction on the dollar has gone too far. It would be appropriate for the dollar to be somewhat higher with potential for further appreciation as the improved fundamentals become apparent in the period ahead.

The United States is firmly committed to its dollar support program, and to playing an active role in helping to achieve and maintain international monetary stability.

Responsible monetary policy

Finally, a word about monetary policy in the war against inflation. Of course, monetary policy must play a key role. The Federal Reserve therefore moved early and progressively this year to apply monetary restraint and reduce

the growth of money and credit. The Federal funds rate and short term interest rates have risen more than three percentage points since the beginning of 1978. Consistent with normal lag effects, the growth rate of the monetary aggregates has slowed appreciably over the past two months. The Federal Reserve intends to continue working toward a gradual deceleration of monetary and credit expansion to a pace consistent with price stability. The task of monetary policy will be aided by the concurrent pursuit of tighter fiscal policy. We are determined to see that the inflation rate is pushed in the right direction -- down toward zero -- and that it is kept moving in that direction until we reach that level.

Slower economic growth

The short term goal of all these policies has been to effect an immediate slowdown in the growth rate of the U.S. economy, while maintaining balanced conditions. The original growth target for 1978 was a 4-3/4 per cent increase in real GNP. With the planned slowdown, the rate will now be about 3-3/4 per cent.

Outlook for 1979

The economy is, in fact, in remarkable balance, with no significant overextension or underutilization. Steps were taken in the spring, through authorization of new types of savings instruments, to avoid the heavy disintermediation and the consequent depressing effects on housing construction which proved so disruptive in past economic cycles.

With continued monetary and fiscal discipline, the outlook for 1979 is for real growth of 2-1/2 to 3 per cent. Unemployment may increase only moderately, with a slower growth in the labor force. Inflation will begin to move down, declining on the order of one percentage point.

Because of the balance in the economy and the absence of excesses a recession is not indicated for 1979. Our objective will be to maintain slower growth for a considerable period of time, working off inflation but avoiding disruption of international economic progress.

The slower rate of U.S. growth next year, along with higher growth rates in Germany and elsewhere, will contribute toward a reduction in the U.S. current account deficit. The deficit this year will be in the $16 to $18 billion range; in 1979 it should be down by 40 to 50 per cent, to under $10 billion.

European Monetary System

Let me take this opportunity to comment on the new European Monetary System that will go into effect at the beginning of the year. For over thirty years the United States has favored economic integration in Western Europe, and so naturally we welcome steps toward monetary integration.

The EMS is a creative and courageous concept. There is some risk, as with any major innovation, and apparently it will not be possible for all the contemplated participants to join in initially, but the new arrangement is a constructive approach toward greater monetary stability. All of us stand to benefit, and we wish you complete success in this important venture.

New directions of U.S. policy

My purpose today has been to outline the new directions of U.S. policy. Inflation is our number one problem. The United States has declared war on inflation and has moved steadily to mobilize its full resources to wage the battle. A broad and growing array of policy weapons has been brought to bear. The President has taken the lead and placed his political prospects on the line. The entire government has been enlisted for the duration. The American people are committed to victory.

We are unwavering in our determination to fight the war as long as necessary. We shall persist. We shall prevail. We shall overcome.

International economic order

The temendous cooperation we have received from the Bundesbank and the German government is deeply appreciated and provides a great source of strength. We share a common interest -- Germany and the United States and all nations and all peoples -- in having a stable international economic order. Only then will our countries be able to provide for the needs and wants of people. Only then will it be possible to fulfill on a continuous basis our mutual goals of full employment, price stability and sound and stable currencies.

And only then we will have assured the greatest prospects for universal prosperity and for a peaceful world.