

Remarks

by

G. William Miller

Chairman

Board of Governors of the Federal Reserve System

before

Business Outlook Luncheon

The Washington Post

Washington, D.C.

January 9, 1979

What I would like to do today is make a few comments about the outlook for the economy and perhaps, if it's appropriate, take whatever time we have remaining for some of your questions. It may be more interesting to find out about the outlook for '79 through what's on your minds than what's on the mind of the central bank.

Let me just set the stage for a moment by saying that if one thinks back from this generation of activity to World War II, there haven't been too many decades that have been entirely brilliant. Each has been characterized by some major shock or discontinuity or trouble in the world. And yet, even if we look back all that way to the difficulties of reordering the world after that great conflict, we're hard pressed to find anything as sobering as the decade of the '70's. So, in starting to think about the outlook for '79, I'd like to make one simple prediction, and I think it will prove to be true. That 1979 is the last year of a dismal decade and we can look forward to something better in the future.

It has been a sobering period. We entered this decade trying to extricate ourselves from a very unpopular and expensive war which was one of the fundamental causes of our persistent inflation problem. That led to a trial of direct wage and price controls that were both inequitable and ineffective, and when those controls were lifted, conditions had been ripened for an acceleration of inflation to double-digit levels with double-digit interest rates. This was coincident with and followed by the breakdown of the International Monetary System, the demonetizing of gold, the oil boycott,

the quintupling of the price of petroleum, Watergate, and a breakdown of faith in all institutions, leaving us with the most serious recession we have suffered since the great depression and with all of the strains and trials and tribulations of working our way out of that period.

It has indeed been a sobering period. But we live in a world of change; our whole world has been changing during this period. It's changed through technology. It's changed demographically, socially, through international reordering, and through a series of shocks that have hit us from all directions. So when we begin to assess where we are and where we might be going, it's indeed sometimes a trying experience. But let me try to do so.

In the first place, where we're going depends on where we have been and what we've been trying to do. And the first question we have to ask ourselves in assessing where we're going, is: Have we developed any strategy in our economy to deal with the unusual problems we face? Do we have a plan and a program that has any chance of success? I think you're better prepared to answer that than I am. I know that in the short time I've been in Washington there has been very important discussion and debate over the primary economic policy issues, and that rather dramatic changes have taken place.

When I came to Washington, the expectation for the fiscal year we're now in -- FY-'79 -- was for a budget deficit of over \$60 billion. It didn't

take but a short time for both the Administration and Congress to realize that that was an unacceptable program if we were to have any chance of controlling inflation and working back to a period of price stability, full employment, and a sound dollar. So the fiscal plan was changed to a greater degree than any I can ever remember. The change was from a \$60 billion deficit to a \$38 billion deficit, with a commitment from the Administration to bring in another tight budget with a deficit of less than \$30 billion in fiscal year 1980. The task of bringing the deficit down to that level may not seem like tremendous progress. But in view of the fact that so many Government programs have been layered on top of each other over the years, and that there are so many commitments to programs that are very difficult to change, it does take an enormous effort to bring in a budget with even that kind of deficit. So I think we have to give a good deal of credit to the Administration and to Congress for this new fiscal direction.

The second new direction, of course, has been to deal with the dollar. A year ago, the attitude about the dollar was that it would adjust itself and that the natural process of international alignment would be adequate. It's now apparent -- and policies have been changed accordingly -- that the United States must take forceful action and must be willing to take some degree of risk to be sure that we have a sound and stable dollar. We must

take those actions on the dollar that are necessary so that our own economic harvest will be enhanced and so that the world's financial and monetary system can work.

Let me suggest that the outlook for 1979 really depends on continuing a series of such new directions that were initiated in 1978. Let me just tick off a few more of those new directions and then analyze how I see them impacting on '79 and the years beyond.

There has been, in 1978, a mobilization of economic and financial and monetary weapons to combat inflation. There have been put in place at least six major weapons systems to deal with inflation. The first is fiscal policy. The second is incomes policy. The third is a reduction of regulatory burdens. The fourth is productivity. The fifth is a balance of international accounts. And the sixth is a disciplined monetary policy. All of these have received tremendous attention and a new emphasis.

I've already mentioned fiscal policy; I won't add to that. An incomes policy is now in the process of being tested -- not because it will make a fundamental contribution to reducing inflation, but because it will buy us time. It is a bridging action that will allow the fundamental actions in fiscal and monetary areas to have their effect. If, in fact, the oil and chemical and atomic workers settlement, which is now in the process of negotiation, should be in compliance with the Administration's standards, that will surely be a signal that incomes policy is making a contribution as a new direction in dealing with inflation.

The third area that I mentioned was reduction of regulatory burden. It is perhaps as important as any of these various weapon systems, but it is also the one that will probably show the least results and whose results will be most difficult to measure in the short term. In the long term it is essential that we reevaluate regulatory costs in relation to public benefit. But, in the short term, the reordering of these regulatory processes is difficult, time consuming, and has a delayed effect.

The fourth area is productivity. For the first twenty years after World War II, the United States had the greatest productivity gains of any nation in the world. This was one of the principal reasons it was possible for us to assure every American of an annual increase in real income. The last ten years, we have fallen woefully behind the rest of the world in productivity; and for the last five years we've fallen even further behind to where we're only now at an average rate of about 1-1/3 per cent year increase in productivity. This makes it impossible for us to digest the forces of inflation and to maintain our competitiveness in the world. Here, we need a major thrust to create those incentives which will assure a greater emphasis within the economy on business fixed investment, which is the best way to assure that we become more efficient in our production, reduce our unit costs, and thereby fight inflation. It assures also that we renew our technology, that we renew our competitiveness, and that we improve our capacity to emerge in the '80's as an effective industrial economy.

The fifth area is balance in our international account. The decline of the dollar is certainly closely related to our entire problem of inflation. It's very difficult for us to realize how deeply the policies of the past have embedded us, so that a period of adjustment for the dollar -- a period in which new techniques and new policies emerge -- is essential. One of the most important decisions made by the government in 1978 was the decision, on November 1, to take the anti-inflation measures and the pro-dollar measures that were announced in terms of budget objectives, monetary policy objectives, and resources in foreign currencies to bridge over market conditions and to counter the disorderliness in exchange markets until we could reestablish a sound and stable dollar. Perhaps the most unusual part of our package was the decision that, for the first time in its history, the United States would issue foreign-currency denominated obligations. That decision had a far reaching impact in terms of our capacity to finance our current account deficit and also our capacity to bridge over the disorderliness in the exchange relationships of the dollar until fundamental adjustments could take place.

Finally, as the sixth new direction, we have a disciplined monetary policy. I'd just like to give the Federal Reserve's point of view of what we've tried to accomplish in 1978 and what we're doing in the years ahead.

First, we've been deliberately endeavoring to restrain and lower the rate of real growth in the economy. The rate of growth that was projected a year ago was too rapid if we were to have any chance of banking the fires of inflation, which were then cost-push but were moving rapidly into demand-pull. As a result of combined efforts -- monetary, fiscal, and other efforts -- the real rate of growth of the economy has been brought down from the 4-3/4 to 5 per cent originally estimated for 1978 to a rate that will probably be about 3-3/4 per cent. Our effort is aimed at continuing to dampen the rate of growth of the economy in order to take the steam out of inflationary forces.

Our second objective in monetary policy has been to apply the restraint and to make the adjustment smoothly, to avoid disruptions and dislocations in the economy. The third objective has been to maintain the balance in the economy so that no one sector would bear an undue burden. For example, early in the spring we authorized the new money market certificates that allowed the housing industry, through the thrift institutions, to compete for money in the market and therefore to maintain a flow of funds into the mortgage market to sustain the housing industry. This was the first time in recent experience when it was possible, despite the other demands for credit in other sectors of the economy, for the housing industry to continue at a reasonable level. Our purpose in seeking balance was to avoid any one sector being sent into a tail-spin and thereby pulling the whole economy down.

Our final objective has been to accomplish all of this without being fearful of a lower rate of growth for a sustained period of time but without triggering a recession. There is no reason I know of why we should not continue to pursue these objectives and why we should not continue to have a forceful and determined commitment to the restraint and austerity in monetary policy that will assure that we wring out these forces of inflation and not allow them to reassert themselves.

Now these kinds of policies carry with them a degree of risk, as you all know. When the November 1 action was taken it was only a matter of days before many economists were beginning to predict a recession. It has been my view, as you know -- and the Federal Reserve's view -- that the actions taken in '78 would not themselves lead automatically to a recession in '79. And it is still my view, from the economic data that I have seen, that there is not at hand a case for a recession. That does not, however, by any means suggest that we can relax our vigil or that we can reduce our determination to make 1979 a year of austerity in which we apply all of the disciplines of fiscal, monetary, and other government policies to contain the forces of inflation and the dislocations in domestic and international markets and to reestablish conditions for progressive, but more moderate growth. In this way, over a period of five or six or seven years, we can bring ourselves into an era when America is returned to its capacity as a leading industrial

nation, efficient, effective, able to produce the goods and services it needs, and able to reestablish once again its own merit in international affairs based on its own economic vitality.

The outlook is one of difficulty. The outlook is such that excessive economic growth will be bad news; negative economic growth will be bad news. Moderate growth, in the 2 to 3 per cent area, will be considered appropriate. And we need a commitment, not only in '79 but in the years ahead, to continue this process until we have finally not only mobilized our forces but also engaged the enemy of inflation and been victorious in the long and difficult struggle. The outlook is sobering, as has been the decade of the '70's. But the prospect would seem to me to be very much more open for meeting all of our national objectives in the '80's if we have the will, the determination, and the capacity to continue in these new directions and not to falter or weaken in the face of transitory factors.

APPENDIX

Questions and Answers

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Question on Regulatory Burden:

MILLER: Yes. I pointed out that it is terribly important to reduce the regulatory burden because we have imposed inflationary costs upon our economic system, in many cases without adequate commensurate benefit. There are many areas where we must impose those costs to obtain the benefit. But there are many areas where we have really not done a proper analysis. We know, for example, that a good deal of deregulation in the airline industry has proved to be powerful in increasing competition, in reducing costs and in reducing prices from what they would have been. So there we have a clear example of how certain kinds of deregulation, reducing burdens and restraints, can be beneficial.

When it comes to other kinds of regulatory burden -- those which relate to health, safety, environment -- the issues become more complex because none of us would want to jeopardize the safety, health, or well-being of any person on the basis of money alone. But in our enthusiasm and our aspiration for perfection, quite often we have added burdens without being certain that there was a benefit. And here I must say that the joining of the issues and the process of persuasion will be long and it will be tortuous. We must recognize that. But I think it's terribly critical that we do join the issues and that we do gather the data.

We should move rationally and objectively to see if we cannot accomplish our task and our goals, while at the same time giving due consideration to the

needs of society. You must remember that if inflation continues at the same rate that we had in 1978, then in the working lifetime of any young person from the age of 25 to the age of 65, that individual would find his or her present dollar at age 65 worth less than a dime. If that happens it would destroy values, real incomes, incentives and investments and would create extreme hardships. So we've got to weigh those things in our analysis and I'm sure that we can do a great deal.

The Federal Reserve is not a major regulatory agency in the total economy. But even in its own field, it's loaded a good deal of burden on banks and we are in the process of examining and rewriting and redoing every regulation we have. We intend to complete this project by the end of this year within the mandates we have from Congress. I hope we can create an atmosphere in Washington where every agency and every department will want to do the same.

QUESTION: Do you feel that Congress and the Administration have the resolve to lick inflation, to carry it through election year next year?

MILLER: I think you all could hear that question. The interesting thing to me when I came to Washington (many of us from the provinces have pre-conceived ideas about Washington), is that I found a much more pervasive attitude of the willingness to tackle inflation than I had expected. With the turnover in Congress and many new Congressmen, the natural lore was that there was,

perhaps less fiscal responsibility and more interest in programs and issues. And yet I found generally in Congress and certainly among many of the new Congressmen a tremendous interest in these new directions of fiscal-monetary responsibility and regulatory responsibility. What would be evidence to me of the prospects for continuing that would be the following:

This attitude began to show up after the April recess of Congress when constituents spoke loud and clear that their primary concern was inflation. That was followed by Proposition 13 which was another loud and clear statement that the American people are concerned about the burden of government and the burden of inflation upon their lives and their hopes. That becomes a political force and therein is the best reason that those who seek to serve the Government through election will be responsive to that force. I don't believe American opinion can be reshifted quickly and I think that American concern and opinion will continue through the election in 1980 and will be the issue in 1980.

Secondly, I find that members of Congress were willing in an election year, 1978, to forego the advantage of a large tax reduction and were willing to cut it back, were willing to defer it and were willing to give only enough tax reduction to offset the tax increase of social security in an election year. And those who did that seemed to get more votes than those who didn't. That seems to me to be the sustaining evidence. Everything I've heard from talking

with leadership in Congress would indicate that they are absolutely with it on committing to this austerity and a measuring up to the responsibility. Add to that the very deep commitment the President has, in my opinion, to move toward lower Federal deficits and to a balanced budget and his willingness to reduce Federal spending in FY 1980 below the current service levels in order to make that objective, and I believe one has the conditions for a continuity. I think it would be politically dangerous for any of the members of Congress or the Administration to stray from that objective at this time. Yes sir.

QUESTION: Question on credit controls

MILLER: Well there are times when consumer credit and other forms of credit need to be controlled. We had conditions in 1973 and 1974 which were rather chaotic following the direct wage and price controls and there were dangers of real crunches. Yet, I would say that present conditions would not indicate that and I believe that credit controls would be unwise and undesirable.

Let me tell you why. In the first place, the process of allocating credit is itself a very challenging assignment. I don't know that any of us want to play God and decide whether it's automobiles we build, or houses we build, or refrigerators, or fur coats we make, or what we do. When you put in credit controls that's what you have to do and I'm not sure

that I want to be in a position of making the social judgment of whether it's better to lay off people in the automobile business than it is some other business. I think that's unsound. One of our objectives is to keep the economy balanced so that we don't have to do that. If you restrain the general availability of credit, as we've been doing, then what happens is that the highest and best uses take the credit that's available and the less beneficial uses in the market place are willing to defer. I think that's a better allocation system than one of direct controls.

We often hear: "Why don't you go to the banks and force them to stop making nonproductive loans." Well how many nonproductive loans are there in the economy? A billion dollars? Well you can't even find that in the \$400 billion of credit that's extended in a year. Do we really want to go with that kind of restraint on the freedom of our system, or do we want, which I prefer, to recognize that probably much of our problem is because we naively thought we could handle this in the past by control. We'd be better off if we would set the parameter and then let the internal system work out its own adjustments, and that's what I certainly would favor.

I get amused sometimes because when I came here ten months ago I was told by everyone how important it was that I demonstrate to the world my determination to bring down the rate of growth of the money supply. So we've done that and nobody's written about it. Instead they've discovered the

monetary base and they don't know what it is. But it's a new thing to talk about. So now it's "controls." Well I'm sure we'll find another icon next year.

QUESTION: Question on factors outside government affecting inflation.

MILLER: Inflation has been built up over 12 years and it's a general complaint that this has been fundamentally government based. It's an unfortunate position for me to be in -- to be one of those who caused all this inflation. You've probably noticed that I'm marked from time to time by the Chairman of the Senate Banking Committee, and he's discovered this year that I've created this inflation and caused all of this. The truth is that it has been more governmentally created than privately created.

Let me give you the litany. How did this inflation start? Let's go back to the whole post-war era. The United States has the best record in the world on inflation. It had very low rates of inflation until the decade of the 1970's. During the first half of the decade of the 1960's it had the best record in its own history of economic growth, productivity and zero inflation and full employment. What went wrong was, first, failing to pay for the Vietnamese war. That started it. We did not as a nation become committed to that action, and therefore we weren't willing to tax ourselves and to pay for it. We began running up the deficit. So for many years now we've only been balanced for two years in a long period of time, and this triggered the beginning of a series of unfortunate policies that added to the problem. Because once inflation

started, one response in 1971 was to put in wage and price controls. All that did was put a lid on top of the problem so that the economy could be steamed up. Everything was going gang busters through election time and then when the lid came off, it blew into double-digit inflation and double-digit interest rates and that of course helped to contribute to the conditions where the oil boycott was successful. There were other factors, but that was one of them. Our weakened condition -- where we were suddenly rather indefensible because of our involvement in Vietnam and our involvement with these problems and things like Watergate -- obviously contributed to an incapacity of Government to respond. We never got back to fundamentals.

On the private side, the thing that has contributed most to inflation is the lack of investment. Now that is probably the result of conditions that were so uncertain, and so unpredictable, that there was a disincentive to invest. But the dropping off of investment has been probably the major contributing factor from the private side toward conditions that have fueled inflation.

Let me just give you a little statistic. In the whole history of this republic, for almost 200 years through 1971, we had built up our Federal debt up to \$450 billion. By the end of this year we'll have doubled that. Now you can't do that without creating inflation. Just no way. And unless

we recognize that fundamental and do something about it, it's going to be a continual threat to this nation. I wish there were a simple answer. There isn't. There are no sweet, quick simple answers. There has to be a continued willingness to get back to blocking and tackling and fundamentals. We have to stick with it. We have to be undeterred from our determination. Inflation is a greater risk to our society than any other risk we face. If we fail, the new base of inflation becomes the floor for the next round. And that becomes the floor for the next round until you finally trigger an inflation that wrecks any society. It was inflation during the Weimar Republic that lead to the rise of Hitler and to 50 million people being slaughtered.

We have a strong people, a strong nation, a strong economy. But it's not invulnerable forever if we don't recognize the fundamentals. We will. I want to leave you today with a note personally of great confidence that we are mobilizing our arsenal of weapons. That we are engaging the enemy, that we are working on the reserve forces that will be necessary to bring into play if we need them, and that we are going to show the determination, will and commitment, that we are going to succeed. Thank you all very much.