INFLATION--CLEAR AND PRESENT DANGER

Comments by

G. William Miller

Chairman, Board of Governors of the Federal Reserve System

Meeting with San Francisco Community Leaders and

Joint Boards of Directors,

Federal Reserve Bank of San Francisco

San Francisco, California

February 8, 1979

Inflation--Clear and Present Danger

Ladies and gentlemen, I'm particularly pleased to be here in San Francisco today. I'm here for a reason that has to do with my general stewardship while I'm in the Federal Reserve. And that is a belief that I should visit the various components of the Federal Reserve System on a regular basis, so that I can have direct contact with what's really going on in the American economy and what's going on with the leadership of the Federal Reserve and the leadership of all our communities. This keeps me from becoming insulated in Washington with viewpoints that are too sterile and too unrelated to reality. There is a good deal more reality in San Francisco than in Washington.

I want to add my personal appreciation to the directors of the Federal Reserve Bank of San Francisco and of the branches. This is indeed a very big territory, and it shows how this great nation has developed when you realize what changes have taken place in this district since the Federal Reserve System was set up in 1913. If it were being set up today, I'm sure you'd get more than one bank. The amazing thing about the original Federal Reserve System is that the senator who had the most to do with it got two reserve banks for his state. And considering the politics of today, I'm sure that California might get two reserve banks. Who knows?

The arrangements for my table were particularly well thought out, because it was possible at lunch before I stepped up here to speak to get all the inputs I need for an analysis of the economy. The Gross

National Product is tied to Levis, and so the discussion of the jeans business gave me the GNP. And as you know, the price structure depends on the tuition at Stanford -- and so I got that all straightened out. And Bill Haynes gave me some input on government finance, since he is selling savings bonds. (He even has a savings-bond tie on.) So I really was able to put the whole economy together at lunch, and what I'm going to say now is obviously what I've just picked up.

Many of you may not know it, but you have had the burden placed on you of having me represent this district in Washington. Every governor of the Federal Reserve, including the chairman, must be appointed from a different district -- and I'm appointed from California. So yesterday I went back to Berkeley to visit Boalt Hall, where I graduated from law school in 1952 -- and it was a wonderful experience to be back chatting with the faculty and visiting the campus. And I'm delighted that Dean Sandy Kadish is here with us for this luncheon. He was nice enough yesterday to show me not only the new and expanded Boalt Hall, but also the old Boalt Hall. This is now a school for oriental languages, which is particularly pertinent of course in today's world. So, my experiences at Berkeley have been translated into all the great economic and political problems of the day.

As you already heard, I was here last June at the invitation of Arjay Miller to speak to the Bay Area Council, which was certainly a privilege for me. It seems to me that we are still facing the economic issues that we were facing at that time. I thought it might be appropriate, since many of you who attended that meeting probably tossed my speech away, simply to repeat that earlier speech. At least I ought to start this discussion by hitting some of the highlights of what I was trying to say in that particular evening.

First, I was trying to point out that inflation is a clear and present danger, that it is a real threat to the welfare of this nation, and that it has the potential of disrupting our society unless we deal with it forcefully. And so it is today that inflation still is our most critical national problem.

A second point that I was trying to make is that the current inflation has built up over a dozen years. It has brought us to where we have an unprecedented experience with high rates of inflation in peacetime. This phenomenon is not new to other nations but it is new to us, and so we've had trouble coming to grips with it. It has built up over a long time, and because of that it has become deeply imbedded in our system. And because it is so deeply imbedded, it's going to take new initiatives, new understanding and new persistence if we are to wring it out of the economy.

A third point I was making at that time was that anti-inflation efforts should not be left to monetary policy alone. Because if we attempt to do so, the range of possible policy responses would be so narrow, and the degree to which monetary policy would have to impinge upon the economy would be so painful, that our policy probably would not survive the political mechanism. Therefore, it is important that we marshall other government policies in order to deal with the issue, and not leave it to the monetary authorities alone.

A fourth point I was making -- and this was the main thrust of my speech -- was that there needed to be new directions in economic policy along a number of fronts if we were going to be successful in wringing out inflation. And the fifth was that the war against inflation would need to be unconditional and sustained over many years if we were to be successful.

Now we can pick up from that point, and perhaps review some of the developments since that time. Since June, we have made some progress. There have been some significant changes in government policy. Not all of them have come about easily, but nonetheless the changes are taking place. The United States has moved progressively to mobilize a substantial arsenal of weapons to carry on the war against inflation. I'd like to mention just a few of these weapons and some of the implications: first, fiscal policy; second, incomes policy; third, reduction in regulatory burdens; fourth, revitalization of productivity; fifth, a balance in our international accounts; and sixth, a monetary policy which complements and supports the other elements.

In the case of fiscal policy, there has been a major shift towards tighter control over Federal spending and a corresponding reduction in the Federal deficit. Perhaps this has not been to the degree that everyone would like, but at least the direction has been changed. The original Federal government plan for fiscal 1979, which began last October 1, was modified to reduce spending and to cut back on tax reduction so as to shrink the proposed deficit from $60 billion to $38 billion. That was a $22-billion shift in policy from the time that I was here in June until the final decisions were made. And while again many of us could argue for additional action, at least that was a major change in direction. The President and the Congress demonstrated in this their resolve to act in the fiscal area. That amount of shift was unprecedented. I've never seen a case, none of us have seen a case, where the President presents a plan in January and within the course of several months is willing to shift that much out of his plan. I think we should commend the Congress and the President for that particular action. And the new budget proposes to continue in the direction of reduction, so that we're looking at a proposed deficit of $29 billion for fiscal year 1980. Again, it may not be the degree that all of us would like, but the direction is right.

This application of fiscal restraint has a further goal, it seems to me, that is beginning to be more understood. That goal is to reduce the relative role of government in the American economy. This is important if we are to use our resources more efficiently and effectively. The emerging pattern means that we have the prospects of reducing Federal-government expenditures from over 22 percent of Gross National Product down toward 20 percent. And over a number of years -- four, five, or six years -- this has the potential of shifting some $60 to $70 billion from the public sector to the private sector, where the spending and investment decisions of individuals and businesses will be far more beneficial in their impact upon economic progress.

A second policy area is incomes policy. Last 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 anywhere that I know of in the government for the reintroduction of mandatory controls, which are inequitable and ineffective. But it does seem to me that 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 the prospects for real gains in compensation and profits. This program started off on a very negative note, and it took some time for the specific standards to be developed and understood, but nonetheless, there seems to be a growing acceptance of the concept. Most of the leading corporations have now pledged their willingness to comply. The settlement of the oil companies recently with the Oil, Chemical and Atomic Workers within the standards is also an encouraging sign -- an indication that there can be cooperation from labor unions. Support by management and labor of the President's program can certainly make a contribution toward breaking the cycle of wages chasing prices and prices chasing wages. And most important, support for this program can give the time for more fundamental fiscal and monetary policies to take effect.

A third policy, a third weapons system, that can be marshalled in the fight against inflation concerns the reduction of regulatory burdens, which have added very greatly to costs and thus to prices without any commensurate public benefits. This doesn't mean that we have to give up legitimate social objectives, or objectives in terms of the safety of our work places or our living environments. But we can be sensible about the application of regulations, and relate them more to the benefits that society may experience. Now I will be the first to say that unwinding these unnecessary regulatory burdens will take time. And it's going to require redirection in legislative and administrative areas that will not be easy to bring about. And I'm doubtful, frankly, that there will be much short-term effect from this effort. But I think that we must keep the pressure on this area, and in the long-term it is very important that we unleash the American enterprise system from the unneeded and costly restraints on its flexibility, its responsiveness and its creative capacities. And I do believe that the Administration has made a commitment toward this objective.

A fourth policy component is directed toward revitalizing productivity. During the first 20 years after World War II, productivity gains in the United States were the highest in the world, running about 3 1/3 or 3 1/2 percent annually. This provided the foundation for annual increases in real income for all Americans. This also helped counter inflationary pressures, and contributed to a period of prosperity and real progress. But for the last ten years, we have fallen woefully behind in our productivity -- fallen behind other nations, and fallen behind our own past performance. Some steps were taken in the last Congress to achieve the kinds of productivity gains we must have, but they were very modest and inadequate. Let me illustrate the problem by indicating that in Japan 20 percent of GNP is devoted to fixed capital investment. In Germany the figure is 15 percent, but in the United States it is only 8 or 10 percent. And as the years roll by with us investing less and less in relation to the growth of our labor force, we are falling further and further behind. This productivity weapon has hardly been used in recent years, and it needs great attention if we are going to be successful in the long term in dealing with our inflation problem.

The fifth area I want to mention is the international area. This involves the marshalling of policies and resources to bring into balance our international accounts. The decline of the dollar in foreign-exchange markets over the past year and a half is very much linked to the U.S. inflation problem and to our current-account deficit. The decline of the dollar at the same time has been one of the causes of our inflation, because we must pay more for essential imports while the competition from imports is reduced in relation to domestically produced goods.

One of the contributing factors to our trade deficit and hence to our current-account deficit has been the heavy U.S. requirement for imported oil. The problem had its origins early in the history of this nation. For a long time, America was a vast, sparsely populated continent with seemingly inexhaustable and inexpensive supplies of energy. We built this great industrial nation in part by taking advantage of cheap energy, sometimes in substitution for capital and labor. There is nothing wrong with that at all. But in time, with our ever-increasing demand, the limitation of domestic supplies finally became a reality. Now we are going to have to devote ourselves, for a substantial period of time, to converting our industrial facilities, our transportation equipment, our housing stock, and our commercial installations to a more energy-efficient mode, in line with other industrial nations who never had the benefit of cheap energy.

The United States also is going to have to pay far more attention to shifting to alternate sources of indigenous fuel. Because the United States is a heterogeneous nation, with many regional differences as between producing and consuming areas, it has been very difficult to hammer out national energy policies. We are like a group of separate nations where some are producers and some are consumers -- except that all of them happen to be inside one nation. It's been excruciatingly difficult, and we haven't been successful enough, but we should remember that there is a reason why we have these internal problems.

We finally made some progress in the 95th Congress -- perhaps not perfect progress -- but at least we began to move in the right direction. We were dealing, among other things, with conservation, conversion to coal, and the new natural-gas bill. This natural-gas law creates a single, national market where previously we had two markets -- the higher-priced intrastate market with a surplus, and the regulated interstate market with uncertain supplies and shortages and difficulties in planning and developing industrial applications. As a consequence of the new law, we now have abundant and indeed surplus supplies nationally -- and we are suddenly talking about converting back from other sources to natural gas, when just a short time ago we were talking about curtailing.

This shows the search for workable policies. It shows at least that we are beginning slowly, at last, to come to grips with our problems, although we still have more to go. We must give more consideration, quickly it seems to me, to moving domestic oil prices toward world prices, in order for us to make the adjustments that are essential. And when we see how the events in Iran have interrupted world supplies and created pressures on the availability and cost of oil, we can see how urgent it is that we address the energy problem.

All the factors I've mentioned have influenced the decline of the dollar. In any event, it certainly was disheartening to see some of the market actions last year. By late October, the lower exchange value of the dollar could not be explained by fundamental developments such as inflation and current-account positions. But whatever the cause, something had to be done because of the importance of the dollar as a world currency. The Administration and the Federal Reserve, in cooperation with the governments and the central banks of Germany, Switzerland, and Japan, decided to act forcefully to correct the excessive depreciation of the dollar. The measures we announced on November 1 included a substantial increase in foreign-currency resources immediately available for intervention, expanded gold sales, and a further sharp tightening of U.S. monetary policy. The monetary actions -- the Federal Reserve's principal concern -- included a 1-percent increase in the discount rate, the largest increase since the bank crisis of the early 1930's. Parallel to that was an increase in the Federal-funds rate and an increase in reserve requirements for large certificates of deposit.

The marshalling of foreign-currency resources for intervention, which was in addition to the direct intervention by other central banks, involved an initial total of $30 billion in Deutsche marks, Swiss francs, and Japanese yen. The package included swap arrangements through the Federal Reserve, U.S. Treasury drawings from the International Monetary Fund, Treasury sales of special drawing rights, and a U.S. Treasury program for the sale of foreign-currency-denominated obligations. This sale 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 Deutsche marks and Swiss francs, have already been successfully offered, and each issue has been over-subscribed.

It is important that we continue the vigorous application of the November 1 measures in order to maintain the conditions for a relatively stable dollar. The initial response was successful. Within a few days after the November 1 action, the dollar improved sharply in relation to all the three currencies, and since then we've had generally a period of relatively stable conditions but with some dislocations of moderate amount and moderate duration. In recent days, particularly because of the Iranian situation, the markets have been in some turmoil, but they still stayed within boundaries that are reasonable in relation to the objectives of this program. The thing I want you to appreciate is that we are committed to continuing forceful action, because a further decline of the dollar would threaten our program of anti-inflation actions, and would disrupt the development of both domestic and international economic progress. So we are firmly committed to this program, and we have substantial resources at our disposal to use in carrying it out.

Finally, after having given all of the nice information about what other parts of government should be doing, we might say a word about the Federal Reserve and its monetary policy. Of course, we have a key role to play. The Federal Reserve has recognized its responsibility, and has moved forcefully over the last year and has progressively applied monetary restraint on the growth of money and credit. The Federal-funds and short-term interest rates have risen more than 3 percentage points since the beginning of 1978, and consistent with the normal lag effects, the growth of the monetary aggregates has slowed appreciably in the last few months. The Federal Reserve intends to continue working towards a gradual deceleration of monetary and credit expansion, to a pace that is consistent with price stability. The task of monetary policy will be aided if we can have the concurrent pursuit of tighter fiscal policy and other supporting actions. But we are determined to see that inflation is pushed in the right direction -- down toward zero -- and that it is kept moving in that direction until we reach that level.

I might mention briefly some of the objectives that we've had in monetary policy over the past year. One objective is to restrain the economy -- to bring down the rate of real growth to a more sustainable level. A second objective is to apply this restraint smoothly -- without dislocations or disruptions -- and to do this with complete disclosure so that the economic system can adjust to a known path of monetary policy.

A third objective is to bring about this reduction of activity while maintaining a relatively balanced economy -- that is, avoiding pushing the burden of adjustment too much on any one sector. In particular, we authorized the new money-market certificates so that the housing industry, through thrift deposits, could have a better chance at competing for resources and maintaining its relative position, instead of going through the dislocation that we saw in earlier cycles.

Entering 1979, the economy is in reasonable balance, with no significant overextension or underutilization. We are therefore in a position to enter a fifth year of expansion in a mode of declining economic activity, but with reasonable balance. I don't believe that economic expansions die of old age; I think they die of some dislocation that triggers a negative economic result. And at the moment, I don't see any conditions in our economy that would indicate a recession this year. The policy courses we're following, of course, include the risk of recession, and they must because that is inherent in the direction we are trying to move. But I'm not at all sure that present conditions will bring about a recession in 1979. It's more likely that we will see a rate of growth of around 2 percent in real terms, with unemployment increasing moderately and inflation beginning to move down gradually. And here of course is the beginning of a long, hard process in wringing inflation out of our system. Because inflation has built up over so many years, and because it is so deeply imbedded, it's going to take five, six, seven or more years if we are to succeed in this program.

Here is the real challenge. Will we have the determination, the fortitude, the persistence -- will we have the character as a nation --

to stay with these policies and see our way through? Or will we weaken, will we begin to yearn for instant solutions, and will we forego the disciplines that are essential if we are to return to the condition where we can fully achieve our national goals? It's very easy for all of us to recognize those goals; we all want the same thing. We want full employment, price stability, and a sound and stable dollar. The question is not what we want, but how we get there. And how we get there means the pursuit of proper policies, including a forceful and responsive and restraining monetary policy over a number of years. If through your leadership you can help that proposition to be translated into the political realities to sustain this effort, then we shall succeed. We all will be tested. At the Federal Reserve, we will continue to do our best -- but we look for your support and counsel to make it possible for us to achieve those goals. Thank you very much.

# # #

Question-and-Answer Period

Q. Regarding the policy that had to do with regulatory burdens, you didn't seem to be very optimistic about what could be done. Could you quantify the impact that regulations have upon inflation at this time?

A. I'm not sure I can quantify it. According to some viewpoints, there are very large numbers involved -- and you then have to argue benefits against costs. But it is very clear that there are several aspects to this. One is the degree to which regulation inhibits competition. The best example for that of course is the airline industry, where there has been some move toward deregulation. There we've seen a combination of lower fares, greater utilization of resources, and higher profits. So that case is not related to environmental or safety costs. Rather, it has to do with just creating a competitive environment, in which better use of resources can reduce the overall cost. When you come to another case, such as the application of emission standards to automobiles or the achievement of miles-per-hour objectives, the trade-offs are very large. You're talking in terms of tens of billions of dollars and time schedules of several years' duration. Those can amount to a very substantial burden. I am not too optimistic about this area because the constituencies are so emotionally involved that it is very hard to bring logic and economic analysis into play. The Federal Reserve, of course, doesn't operate in this field. We are guilty of putting a regulatory burden on financial institutions, but we are trying to remove at least some of those burdens that we've placed. We are, therefore, reviewing every Federal Reserve regulation -- rewriting and simplifying and eliminating those that we don't need. We hope to accomplish this task by the end of this year. We've involved all of the Federal Reserve banks in trying to reach that goal. Our problem is that most of the burden that we place on institutions is there because of Congressional mandates. So the dismantling of those mandates where they don't have a pay-off is a very difficult task. And that is why I said that we are not anywhere near to making a big dent through this effort. But I think it is critical that we make the effort, if we are going to turn the tide away from this inhibiting regulatory process towards an effective economic system.

Q. What is being done to assure continuity on the Federal Reserve Board?

A. Today is an anniversary for me. This is February 8, and I was sworn in on March 8 -- so I'm 11 months old today. That is great continuity. We have seven members. They're appointed every two years for terms of fourteen years, but recently most of the governors have not served out their terms. There has been a tendency to put in a tour of duty but not the full 14 years, because of the sacrifices that are required and the desire to return to the private sector. We have two vacancies now, and we are hopeful the President will make appointments to those vacancies soon. And we hope that with good fortune, and with good selections, we will begin to stabilize and have more continuity. We are short now in the Federal Reserve of some types of people that I think will contribute to better balance in the Board of Governors. We have excellent professional economists. I'm the only businessman on the Board, and there are four who are professional economists. (They say we are over-represented by businessmen and I say we are over-represented by economists.) But we probably need some commercial bankers and perhaps some experience in other fields -- agriculture or labor or whatever -- to balance off these other skills. So I'm hoping that's what the President will do, and that he will look upon this as an opportunity to create a balanced board that will have prospects for continuity.

# # #