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NEW DIRECTIONS:
STRATEGY FOR ECONOMIC PROGRESS

Remarks by

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before the

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It is a special pleasure for me to be here today. It was just over a year ago that I made my first appearance on the West Coast as Chairman of the Federal Reserve. At that time, I detailed several new directions that could form the blueprint for achievement of our fundamental economic goals. Today, in a sense, I'm here to give a progress report. I want to discuss with you the steps that have been taken over the past year to redirect economic policy and the challenges that persist in perfecting an effective economic strategy in these difficult times.

Indeed, this past year has produced constructive and measurable acceleration in our responses to the present danger: major shifts in economic direction; heightened awareness of the perils of inflation to our Nation's well-being; and individual and collective actions that attest to America's mobilization to meet the crisis. Most important, we have witnessed the essential emergence of a long-range economic strategy for winning the inflation war.

We now face a crucial period in this struggle. The war against inflation has been set back temporarily by another oil price shock. America is being sorely tested. We now need to demonstrate forcefully our will and determination to stay on course despite the prospect of a delay in our timetable -- perhaps by a year or more -- for wringing out inflation.

We will have to adjust our timetable. But we must not succumb to the nebulous peril posed by our frustration at encountering any delay. We must be particularly wary, over the coming months, not

to mold our policies around hasty predictions and reactions. Sudden swings and switches could be our undoing.

On the contrary, as we assess the impact of recent developments, and as we work toward greater energy independence, we must recommit ourselves to the basic long-term strategy. Even as we continue to struggle in coping with day-to-day difficulties, the policies put in place during the past year offer a more promising economic future. And if we persist in these policies, we have the opportunity to make up for lost time and still attain our ultimate goals within the next 5, 6 or 7 years.

Inflation -- The Problem

You are all familiar with the causes of the present virulent inflation, but let me just recap briefly the events that led to our current malaise.

We have now experienced a decade and a half of repetitive and unprecedented shocks. The war in Vietnam divided the country, and failure to pay for that war planted the seeds of inflation.

Inflation was nourished by inadequate policies -- policies that, in retrospect, did not arrest the underlying inflationary pressures. As a result, our present inflation involves not only cyclical forces, but also structural anomalies. Large Federal deficits, excessive government regulation, declines in productivity, legislated cost increases -- these and other structural factors have been contributors to the growing inflation bias. They have weakened

our economic vitality, leaving us even more vulnerable to impacts from external forces, such as the series of stiff increases in foreign petroleum prices.

Moreover, inflation has become resistant to the old-fashioned remedy of recession. During the 1973-75 recession, prices continued to rise nearly 11 per cent. The effects of recession operate to divert us from our basic course: recession entails automatic increases in Federal deficits; increases pressure for additional Federal spending; produces strains from increased unemployment. Recession cannot solve the inflation problem; it only makes it more intractable. Consequently, we need to be steadfast in our efforts to ensure that the present recession remains moderate and does not develop into a more serious downturn.

Because the roots of inflation run deep, the problem was never amenable to a "quick fix." We must reconcile ourselves not to the presence of inflation, but to the fact that we will be -- must be -- waging a long and sustained war. There will be no single cure, no swift victory.

Inflation -- The Response

As the shadow of inflation lengthened last year, a series of significant shifts in attitude took place. Let me briefly enumerate a series of major policy changes which recognize that we cannot treat a single cell to cure the cancer of inflation; we need to work on the whole economic body. Recent events, as I've indicated,

will impact on this strategy and perhaps postpone temporarily the realization of its benefits. But we must resist any pressure to retreat.

The first major change last year was a courageous action to shift fiscal policy from a mode of stimulus to restraint. The original financial plan for 1979 called for a budget deficit of \$61 billion. In an unprecedented redirection of policy, this large deficit was reduced substantially -- now expected to be around \$30 billion -- changing the fiscal stance from stimulus toward restraint. The fiscal year 1980 budget resolution now calls for a further substantial reduction. The President and the Congress should be commended for the degree and the speed with which they reversed the fiscal direction and steered us toward a more appropriate course. We must stay on this path and achieve a balanced budget. And we must reduce the relative role of Federal expenditures as a percent of our gross national product.

The second major new direction was the introduction of an incomes policy calling for voluntary compliance with a program to moderate wage and price increases. Let me dispel, at the outset, a misconception that this is the sole anti-inflation program: it is not. It is only one weapon in the government's arsenal. It is designed to buy the time needed for the more fundamental monetary and fiscal policies to have their effect. And I must say that in

my opinion, the voluntary standards have contributed to smaller increases in price and wages than otherwise would have been experienced. Most major corporations are in compliance with the program, and all but 10 of 130-plus major labor contracts signed since last October are in compliance. Labor, management, and government should continue to work together in striving for a new accord to break the cycle of prices chasing wages and wages chasing prices, an accord that will be in the best interests of every American.

A third important new direction was the forceful action of last November 1 to halt the slide of the dollar. The decline of the dollar in the year prior to November 1978 added 1 percent to the inflation rate last year by increasing the cost of imports and reducing competitive constraints on domestic producers. As these higher costs ripple through the economy, they will add another 1 percent to the inflation rate in 1979. This additional 2 percent inflation over two years constitutes a \$30 billion tax on the American consumer. We must and will continue our commitment to a strong and stable dollar. We cannot afford to unleash another injection of inflation from international monetary pressures.

Energy Policy

Fourth, new directions in energy policies -- looking toward greater energy independence -- have been commenced and President Carter has initiated an urgent and comprehensive program kicked-off by his address to the Nation last Sunday evening.

America is at the end of the era when pools of oil can be sucked up with straws, when we can depend upon abundant and inexpensive oil to light the lamps of the Nation's progress. A nation that has 6 per cent of the world's population but is consuming 30 per cent of its energy -- with an import oil bill that will climb from about \$8-1/2 billion in 1973 to an annual rate of about \$70 billion by the end of 1979 -- needs desperately to change its habits.

Several new energy policies are already in place. The natural gas bill, which establishes a national market for natural gas, has contributed to increased supplies. The President has taken the very important step in the phased deregulation of domestic crude oil prices to create incentives for greater conservation and production. He has just added an additional major step in setting quotas on oil imports, and in committing America to a steady reduction in quantities of imported petroleum.

We must reduce our dependence on oil as an energy source; and we must reduce our dependence on imported oil. All of us need to lend our support to the President in achieving a strong and effective energy program.

Monetary Policy

Finally, in the arsenal of weapons, we have pursued a monetary policy, acting in confluence with other policies, to counter the fundamental inflation problem. Monetary policy has been directed

to reduce progressively the rate of increase in money and credit, and to slow, deliberately, the rate of growth of the economy to a more sustainable level. We have endeavored to accomplish this on a consistent and continuous course to avoid shocks to the economy and to allow time for businesses and individuals to adjust. At the same time, we have sought to maintain balance in the economy so that no one sector would carry too heavy a burden. Clearly, our task has now been made more difficult; the course between greater inflation on the one hand, or a deepening of the pressure entailed in downward adjustment in growth, on the other, is now more treacherous to steer.

Nevertheless, because of the cumulative effect of all the new directions -- reduction in the Federal deficit, compliance with the wage-price program, a stronger dollar, initiation of a more effective energy program, a restraining monetary policy -- the Nation is now in much better shape to weather the storm than it would otherwise have been. There are no major imbalances in the economy: there is no serious overhang in business inventories; consumers have become more cautious in spending as their budgets have been squeezed by rising prices of basic necessities, but they have not been driven from the marketplace; housing has been slowed, but, because of the introduction of money market certificates and other changes that allowed the industry to compete for funds, it has not been shut down as in some past business cycles. We are headed in the right basic direction to wring out inflation over the long haul.

New Directions -- How Far Have We Come?

It was precisely with the long-term view in mind that I suggested a year ago several new economic directions as a blueprint against which we could measure and evaluate our progress. I suggested that we quantify our goals, to give us a clearer picture of where we wanted to be over the next five to seven years.

Let me now "revisit" some of these directions to assess how far we have travelled. Although the timetable may have to be extended, I believe these are still the valid directions to pursue for success in our inflation fight. In fact, if progress continues to be made toward the solution of structural problems in our economy, we could ease considerably the dilemma of choosing between inflation and slow growth.

All of the policy shifts I have described work toward the first new direction I suggested a year ago -- a commitment to fiscal prudence, and, in particular, to reducing the role of the Federal Government in the economy. It is vital that we return more of the spending and investment decisions to the private sector, where their cumulative effect will be to increase the efficiency and effectiveness of the economy's operation. The share of the Federal Government in GNP, at a peak of 22.6 per cent in 1976, has come down slightly to 22 per cent currently. This progress needs to be continued so that over the next three to five years we achieve further reduction of Federal expenditures to about 20 per cent of GNP, thereby freeing about \$50 billion for the private sector.

Reducing the government's share of GNP, in turn, moves us toward the second new direction -- a balanced budget with high employment. Present plans head us down to a deficit of around \$30 billion this fiscal year. The President, the Congress, and the American public are united in support of the goal of a balanced budget. Even in the face of higher unemployment, we must stick to this disciplined fiscal policy.

But when we think about the unemployment figures we should take credit for the present historically high percentage of the adult civilian population that is employed. The capacity of our economy to absorb substantial one-time labor force increases over the past several years has been tremendous. And let us not forget that the best hope for high employment on a continuing basis still lies in wiping out the disease of inflation; inflation is still the primary obstacle to our employment goal.

Last year I also suggested a vigorous program to expand exports. Some progress has been made in the past half-year as export growth accelerated. We must continue this progress, increasing our exports over the coming years from 7 per cent of GNP to 10 per cent. This will help to correct the balance of payments problem and to maintain a strong dollar. But I would stress that further impetus to export growth must come from improved price, product and market performance, not from changes in the dollar exchange rate.

Intertwined with the other points in this blueprint is the commitment to reduce inflation. Over the coming months, we will see only little progress on this front, as increases in the energy and food sectors continue to push up the Consumer Price Index. But this past year has been characterized by a heightened recognition of the inflation peril by the American people, and a deep commitment to give first priority to the war against inflation.

As to the Federal Reserve, we are firmly enlisted in this commitment. We are determined to pursue a monetary policy that will contribute to wringing inflation out of our economic system.

The Investment Challenge

Let me turn now to another new direction that is beginning to take shape. A reduction in Federal expenditures, in combination with our progressive tax structure, should yield sizeable surpluses in the Federal sector during the 1980's. We should use the opportunity, at the appropriate time, to return the fiscal dividend to individuals and businesses through tax reductions. Again, the goal should be to give more spending decisions back to the people.

My personal preference, when the time is right, is for reductions in payroll taxes to aid individuals while at the same time reducing costs that go into prices, and for reductions for businesses which are tied directly to expenditures for new plant and equipment.

This brings me to another important new direction -- the investment challenge. The economic strategy, as I've outlined it, has

contemplated slower growth in the economy to reduce excess demands on resources. This was intended to relieve pressure on capacity -- giving us time to catch our breath and to adjust to a more moderate and sustainable growth rate. With a recession underway, it is now desirable to plan a recovery, led not by stimulus of consumer demand, but by stimulus for investment. We need to prepare for this direction without further delay.

For the first twenty years after World War II, the United States led the world in productivity gains. Each year we averaged about 3-1/3 per cent greater productivity. Those productivity gains provided us with the basis for annual increases in the real income of every American. For the last ten years, our productivity gains have been only two per cent; for the last five years, only one per cent.

There are many reasons why productivity gains have fallen to dangerously low levels. One key reason is that our capital spending has been lagging. The recent growth in the Nation's capital stock has been far lower in net terms than in past cycles; we have not yet even come back to the peak at the height of the last business cycle.

Because capital has grown more slowly than the labor force, we are beginning to fall behind in the investments that are essential to providing the jobs for the future. And we're falling behind other countries: Japan spends more than 20 per cent of its gross national product on capital investments; Germany, 15 per cent of its gross national product; the United States 9 or 10 per cent.

These, then, are the consequences of our under-investment: sluggish productivity gains; limited investment in providing jobs for the future; reduction in export growth due to a faltering competitive position; and a reduced value of the dollar.

My own proposal has been that we endorse a simple formula: 1-5-10. 1-5-10 stands for a new policy of liberalized depreciation under which all mandated investments for environment, safety and health would be written off in one year; all new investments for productive equipment would be written off in five years; and all capital in structures and permanent facilities would be written off in 10. This acceleration of the depreciation allowance offers the most direct and efficient way to boost investment, for two reasons: first, accelerated depreciation ties each dollar of revenue loss directly to capital investment; and, second, because this formula reduces risk and thus gives strong incentive for investment in the cost-saving and modern production facilities. Our estimates indicate that 1-5-10, after five years, could raise the investment share of output close to 1 per cent higher than what it would otherwise have been.

Recently, a bipartisan group of senators and congressmen proposed a variation of this speedup in depreciation. This is an encouraging recognition of the need to spur investment and of the wide support the stepped-up depreciation approach seems to be generating. As the details emerge and proposals become molded in

the Congress, I would encourage each of you to give attention and support to this vital area.

The result of such stimulus to investment would be to reduce the unit cost of production; to reduce the units of energy required for output; to improve our technology; to improve our competitiveness in the world; and to help break the wage-price spiral. We would once again lead the world in research, technology, and production.

Where Are We Headed?

In closing, I will not minimize the impact of recent events on our economic strategy; we will be set back. Nor will I minimize the hardship imposed on individual Americans: the short-term burden will be heavier and the shared responsibility is more urgent.

Over the next several years, we will, in fact, face somewhat slower growth. We will have to accept some shrinkage in our real incomes. But let me suggest to you that collectively we can absorb this reduction in real growth and incomes without commensurate social deprivation. We may surprise ourselves in how innovative we can be in learning to make fewer demands on scarce resources.

Let me give you just one quick example. This past year, forced upon us by the energy crunch, Americans have changed their preferences from gas-hungry automobiles to smaller, more energy-efficient cars. What may have been lost in comfort or satisfaction is minimal compared to what has been gained in energy conservation and in lower pollution. It has not been so difficult a transition as we would have thought.

There are many other areas in which we can explore alternatives and, uninhibited by inertia, tradition, or peer group pressure, find new patterns of consumption similarly free of large social costs.

We do have a strategy. We do have a way out. We can change our habits from consumption to investment; we can save for future growth; we can begin to put back what we have taken out. But we must have the patience and strength to wait for our policies to bear fruit. I believe the American people have that determination.

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