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Economic Outlook for the '80s

Part of the reason the economy has continued to grow, surely reflects anticipations of inflation, anticipations of higher prices later.

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AMONG THE BLESSINGS I count every day is the fact that I don't have to mediate national energy policy. My competence, such as it is, extends only to something so simple, so readily comprehensible and so non-controversial as *monetary policy.*

I've always been surprised somehow that there have been times when one or another of the distinguished representatives of this state in the House of Representatives in Washington have questioned the wisdom of monetary policy and those who run it. So perhaps this is the appropriate time and place for some accounting of what we're doing.

Let me assure you I'm well aware that monetary policy didn't begin on October 6, 1979, when we initiated some actions that took the markets a little by surprise, but that's a convenient starting point for me this afternoon. I won't go into any of the details about that action but we did change our operating tactics and we did change our emphasis, and one immediate result was a certain amount of turbulence in the bond markets, in the capital markets, and in the stock markets.

But amid that turbulence and turmoil, sight should not have been lost of the basic point: what we attempted to convey by those actions on October 6 was our determination to bring money and credit under control. Of course, we did not take that action because those particular figures in the money supply at that time were crucial in themselves — in a sense all those various "M's" that we put out are a statistical abstraction. But there's a reality behind the abstraction: we do operate out of the conviction that the control of money is essential to the control of inflation, and that indeed no inflation has persisted or can persist without being fed by excessive money creation. That's a lesson not just of experience in the United States but elsewhere as well. It's a lesson not just of the past few years but of centuries of history.

There's another point that seems to me equally crucial. Stability in money over time is, in my judgment, critical to sustained and balanced growth in economic

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Chairman Volcker was feature speaker at the Outlook '80 Conferences *held January 15, 1980 in Houston, Texas.* The Texas Business Executive *is pleased to have the opportunity to present these timely remarks for our readers. — The Editors*

> Stability in money over time is critical to sustained and balanced growth in economic activity itself, and that is the end object of economic policy.

activity itself, and that is the end object of economic policy. We used to think we could fine-tune the economy. Among devices and philosophies that were developed was that there was a "trade-off," as the expression went. For instance, you could trade a little inflation for more growth and less unemployment. It even seemed to work for awhile back in the earlier post-war period when most people assumed that we could count on stability. But what we've ended up with after years of practicing that trade-off, or trying to, is both more inflation and more unemployment and less growth. That's been true not just in the United States but in other countries. It's a lesson that's taken time to learn but I think it *is* being learned.

Looking back over these last few months, in a purely financial sense, we can see some clear signs of what I think of as progress. First, and most obviously in light of our expressed intentions at that time, the money supply is on track, it ha slowed down very appreciably from the rates of growth of 10 percent or more that we had during the spring and summer, 1979. Basically we are on the targets that we set for ourselves this past year, both at the beginning of the past year and explicitly reiterated on October 6. Alongside that slower growth in money, credit has slowed — bank credit in particular. U.S. financial markets, I think at this point after the initial turbulence, are more settled. Now having reported on those financial developments I have to quickly add that in terms of the ultimate objectives the picture is less than clear. The good news is that the economy has continued to grow despite almost universal expectations and forecasts by the economists that it would not. It's continued to grow overall despite a clear recession in the automobile industry and despite the difficulties in the housing industry. Part of the reason the economy has continued to grow, part of the reason that spending is high, I think surely reflects anticipations of inflation, anticipations of higher prices later — so we might as well buy now. This has been achieved at the expense of low savings — extraordinarily low savings — which is hardly a healthy situation looking at the problems of the economy in the years ahead.

In a real sense, all those forecasts of recession during this period have been wrong, I think, precisely because we are in a new experience in this country with the anticipations of inflation in the future. It's a situation that our conventional economic analyses and our conventional economic relationships can't handle very well, and I think there are a couple of lessons that grow out of this situation.

First, all the persistent forecasts of recession, for all their recent fallibility, do reflect some real vulnerability in the underlying economic situation. After five years of expansion, after all the distortions of inflation, that's hardly surprising, but I think it is true. At least equally important this experience has shown again, if we didn't know it before, that it's a dangerous game to change basic policies on the basis of short-term forecasts at any particular point in time. Forecasts of the short-run outlook are so often fallible that they're almost as apt to be wrong as right.

In the past, in shaping our national policies, I think we've had an insidious tendency to anticipate the worst in terms of unemployment in particular; and we always anticipate the worst and act upon those anticipations over time. That's a recipe for too much expansionary action and ultimately for inflation. Today our margins for error in that connection are less than they have ever been and I think that we should not make that mistake again.

NOW IF THE GOOD NEWS about the economy is ambiguous at best, the bad news is pretty clear. Inflation remains about where it was three or four months ago. The dollar, while its been reasonably steady in the face of some adverse political as well as economic news, has certainly not been as strong as I would like to see it. The precious metals markets, gold and silver, as well some commodities markets continue to reflect strong speculative influences. While both the action of the gold market and the dollar reflect political as much as economic disturbances in recent weeks and months, I think they also reflect the fact that we haven't made as much progress as I'd like to see towards dealing with uncertainty and inflationary expectations. We should take heart, however, from the fact that in the face of international turmoil and the big new increases in oil prices, domestic markets have remained calm and orderly. But we have to face the fact that physical progress in the price front has been set back by recent developments in energy markets by a quarter or two at best as a result of those prices increases.

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That's not a happy picture, but we always knew there were lags, and sometimes long lags — between action and reaction — so there's no reason in my judgment to be surprised or disenchanted. Monetary policy, specifically restraint on money and credit, can only be effective over a period of time. We do expect to see progress on inflation during 1980 if we stick with it, and we do mean to stick with it.

Maintenance of restraint on credit need not mean unchanged interest rates. I may disappoint you by denying that I am a seer about the future of interest rates. I do know that interest rates in the past, and presumably in the future, will respond to changes in demands for credit and ultimately in the outlook toward inflation. Should business soften as so many anticipate and credit demands thereby decline, some reduction in interest rates would not be surprising. And, if we begin to see the real signs of a decline in inflationary pressures those declines in interest rates could be sustained. Under those conditions a decline in interest rates would be a healthy thing, it would assist the adjustment process in the short run and provide a more favorable climate for investment in the long run. Such a decline would be consistent with restraint on the money supply, it shouldn't be determined as a change in policy or a weakening of our will. But let's not put the cart before the horse, attempts to force interest rates lower at the expense of excessive increases in the money supply would ultimately only be counter-productive. It could only foster, in the first instance, renewed inflationary expectations, in time the expectations would be followed by the reality of more inflation and in the end it would bring in its wake, as sure as night follows day, higher not lower interest rates.

Now I don't mean to suggest that persistent restraint on money, however indispensable it is, is itself an easy, automatic path to renewed price stability, to lower interest rates and to a healthy economy. Success without important economic strains and dislocations is going to depend on a number of other policies. In that connection I've already denied any special expertise in energy, but I think the comments I'm about to make on energy do not require any special genius in that field.

Obviously the state of the oil market is the greatest immediate threat to our economic prospects. One aspect of that, the medium- or longer-run aspect, is the urgent need to reinforce incentives for conservation and production. Whatever particular measures are taken in that connection, however, can hardly be successful without the help of the price mechanism. Even more urgently to my mind right here and now is that we must deal with the anomoly of oil prices rising even while world production apparently exceeds consumption by what should be a comfortable margin. Now we can point the finger at OPEC in connection with oil prices and oil markets. But the fact is at the moment the spot market prices are pulling up OPEC prices — not the reverse. The reason seems pretty clear — uncoordinated stockpiling around the world — stockpiling out of understandable fear of rising prices and shortages of supply. However, that same stockpiling, in turn, brings about the very price increases that are feared in the first place. So nothing seems to me more urgent than to bring that situation under control. One of the most hopeful signs is that the International Energy Agency is hopefully being re-energized itself and is at work on that problem on an international scale because it is indeed one that requires international attention.

The second threat to the economy seems to be more insidious, but perhaps no less important. That is our dismal record — I don't think there's any other word to describe it — in productivity in recent years. I won't go into all the detail but let me just put it in an overall setting. You know, back in the early or mid-60s government proclaimed and business and labor accepted the fact that somehow productivity increased by 3 percent a year and that you could kind of count on that indefinitely. The figure was never quite that high but it was a pretty good approximation of what the previous 20 years had brought. There was a sense that we were entitled to 3 percent growth in real income a year provided out of that productivity. But no sooner did that conviction become imbedded in our minds, than the productivity rate began to decline to something like 2 percent, and in the later 1960s to something more like 1 percent, and then during the 1970s to something like 0 — actually that's being kind — to a minus figure in the past year. Real growth, real income, a higher standard of living, ultimately comes from productivity and when productivity's declining at the same time imported energy prices are rising, living standards inevitably contract and there's nothing we can do about it under those circumstances. We can, of course, ask for a bigger piece of the pie individually and when the pie is not growing we either take it from some-

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body else or we simply have inflation — and that in essence is what's been happening. We can live with the productivity decline or we can try to do something about it. Obviously the latter course seems to be the only reasonable one. The causes of the decline are not completely understood, but one thing that everyone seems in agreement on is that it does have something to do with investment, investment incentives, and that in turn has something to do with fiscal policy — which brings me to taxes.

This country hasn't been kind to investment in its tax policies for many years. Against the background of our economic performance and against the background of the need for more productivity and more investment, the case for well-constructed tax reform and reduction seems to me very strong. In saying that let me point out the obvious: tax reduction does have revenue implications. Tax reduction, with all other things equal in the short run, would increase budgetary deficits. We've made progress in reducing budgetary deficits, but the deficits have been too high for too long. In a very real sense, tax reduction has to be earned by persistent spending restraint over a period of time. The tax reduction should be timed when business requires stimulus. These preconditions are not, in my judgment, present today and for that reason the sense of restraint and I think the sense of responsibility by the Congress and the Administration in resisting premature tax reduction is admirable.

This above all is a period that tests our patience, our wisdom and our common sense. With all the questioning and the uncertainties, I urge that you not overlook our strengths. We've had an exceptionally long period of economic expansion, virtually unprecedented in our peace-time history. We may not have enjoyed that expansion as much as some earlier ones but the fact is we've got about 10 million more people at work in this country than five years ago. By international standards, our growth during this period has been impressive. The dollar's more competitive internationally, our exports have been growing at a particularly rapid rate of speed and our current account on the balance of payments has been getting a little better despite the increased oil influence. Most of all I can't help but be encouraged by the understanding of the American people, reflected in the political process I think in Washington, of some rather elemental truths: the need for restraint; the fact that the creation of money is no substitute for the creation of real goods and real productivity; and the need for consistent and persistent restraint across the framework of government policies.

WE'VE BEEN REMINDED again in recent weeks that we live in a dangerous and uncertain world. We're learning in economics, as well as other policies, about the need for a certain toughness, a certain persistence and realism in approach. I can assure you that in our own area of monetary policy we do mean to persevere with the policy we undertook a few months ago.

***PAUL A. VOLCKER** is Chairman of the Board of Governors of the Federal Reserve System. Mr. Volcker received his B.A. at Princeton University in 1949 and his master's degree in political economy and government from the Harvard University Graduate School of Public Administration in 1951. He attended the London School of Economics in 1951-52. Mr. Volcker's first association with the Federal Reserve System was as a summer employee at the Federal Reserve Bank of New York in 1949 and 1950. He returned to the New York Bank in 1952 as a full-time economist, and remained with the Federal Reserve until 1957 when he became a financial economist at Chase Mahattan Bank. In 1962 Mr. Volcker joined the U.S. Treasury as Director of Financial Analysis and in 1963 he became Deputy Under Secretary of the Treasury for Monetary Affairs. From 1965 to 1969 he was a Vice President of Chase Mahattan Bank. In 1969 he was appointed Under Secretary of the Treasury for Monetary Affairs, where he remained until 1974. During this time Mr. Volcker was the principal United States negotiator in the development and installation of a new international monetary system departing from the fixed exchange rate system after World War II. He spent the academic year 1974-75 at Princeton University as a Senior Fellow in the Woodrow Wilson School of Public and International Affairs. Mr. Volcker became President and Chief Executive Officer of the Federal Reserve Bank of New York on August 1, 1975. He continued in that office until he became Chairman of the Federal Reserve Board for a four-year term beginning August 6, 1979. As President of the Federal Reserve Bank of New York, Mr. Volcker was a continuing Member of the Federal Reserve System's principal monetary policymaking body, the Federal Open Market Committee. He was elected Vice Chairman of the FOMC in 1975. As Chairman of the Federal Reserve Board Mr. Volcker is Chairman of the FOMC.*