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Remarks of

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before the

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I don't know whether it was by design or accident that those who arranged this convention chose to place its locale in the land of fantasy. But it must have occurred to some of you, as it has to me, that perceptions in the economy and in financial markets in recent months have rivaled that mixture of illusion and reality -- of shadow and substance -- so characteristic of the fertile imagination of Walt Disney.

The critical difference is that what is going on outside this land of Disney World in no way resembles entertainment. The fight against inflation is at a crucial point. Just when considerable sentiment developed that the long heralded recession would be further delayed, the business climate changed abruptly. As spring approached, interest rates moved to levels not seen in our lifetime. Financial markets and financial institutions were coming under heavy strain. Some feared the long-term bond markets could be permanently crippled. But, today, less than two months later, some short-term interest rates have dropped almost by half, the public bond markets are absorbing near record amounts of new issues, and some have even questioned whether in some sense markets are not too "easy."

With professional judgments shifting so fast, with different definitions of what is "restraint" or "ease" in policy competing for attention in the press, with simultaneous concern about inflation and recession, is it any wonder that the public is confused and concerned about our prospects and the appropriate policy approach? That confusion can be itself one of the major hazards we face, for perceptions affect behavior. Our fears can have elements of self-

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fulfillment. Impatience for almost instantaneous results and simple answers can detract from the persistence and continuity in policy we need.

For all those reasons, I welcome this opportunity to lay out as clearly and concisely as I can some of the principal elements in my own thinking, particularly as it affects the conduct of monetary policy.

The first quarter of this year apparently represented the culmination of five years of economic expansion. It has been our longest period of peacetime expansion, an expansion accompanied by unprecedented growth of over 14 million (or 19%) in employment. There have been enormous strides in female, and, to a lesser extent, minority participation in the labor force. The highest proportion of our working age population has been at work since those statistics have been kept.

In ordinary circumstances, these achievements might have been hailed with a sense of widespread satisfaction. But instead we have had a sense of unease and disappointment, a sense that, somehow, things are out of kilter. And the fact is those concerns have indeed been justified.

They have been justified in major part by the instinct of our people that lasting prosperity -- to say nothing of our security and sense of social stability -- cannot be built on the shifting sands of inflation and a weak currency. At the same time -- and the phenomenon is in part related to the inflationary process -- growth in productivity has been dismal, whether measured by our own past

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standards or performance abroad. Meanwhile, however much we as a nation have tried to resist the inevitable, the escalation of energy prices and recurrent threats of oil shortage have forced harsh adjustments and new ways of thinking on the average citizen, calling into question a style of life dependent on cheap and abundant energy. Taken together, the higher energy prices and actual declines in productivity have inexorably cut into the real income of most workers over the past year and more -- a matter hard to square with our expectations and our economic behavior.

None of these problems are new. Inflation has been on a rising trend for 15 years. Productivity growth has trended lower for a decade or more. The energy crisis hit with force in 1974. Together they helped account for the severity of the recession in 1974 and 1975. Now, five years later, the economic distortions, the imbalances, and the adjustments that flow from these developments have again threatened to undermine our economy, and even our sense of direction and confidence.

Yet, I also believe we can see now much more hopeful omens. Approaches have begun to be put in place that, in time, can lay the foundation for renewed stability and growth -- assuming we stick with them. Progress may often appear slow and halting. As the adjustments are underway, the threat of recession has appeared. In our impatience for quick results, we can be tempted to strike out in new directions even if over time the proposed measures are likely to be counterproductive. And all of this

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puts a high premium on our economic understanding and on our ability to explain our purposes and policies.

The point has been made, again and again, that dealing with inflation must be a first priority of economic policy. Anticipation of ever accelerating prices is simply inconsistent with business planning, orderly financial markets, adequate savings, and in the last analysis, social cohesion.

Monetary policy has a central role to play in the effort to restore stability. I will not argue that we should "go it alone" -- that persistent close control over the supply of money and credit can, all by itself, assure quick, painless, and precisely predictable results. The inflationary process is too deeply rooted in our society, too complex, too bound up in attitudes and institutional behavior to permit that degree of optimism. But all of economic history does demonstrate with clarity that the inflationary process is nurtured by excessive monetary growth, and that that process cannot be ended without monetary discipline as a key policy ingredient.

It is that discipline to which the Federal Reserve is committed -- a discipline that will be reflected, over time, in restraint on growth in the money supply and credit.

I am acutely conscious of the fact that monetary discipline is often associated in the public -- or even the professional -- mind with high and rising interest rates, with pain and suffering.

Indeed, that can be the case when the demands we place on our economy tend to approach or exceed our capacity to produce, and when money and credit demands burgeon. But we have by now learned

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that, when inflationary anticipations are deep seated and volatile, interest rates -- particularly longer term interest rates -- can be driven up by the fear of inflation itself; in those circumstances, few want to commit their money for fixed returns, and increasing numbers of our citizens would rather "spend now" and "pay later" in depreciated dollars.

For a time, those attitudes can support spending, and provide a kind of false glow to economic activity. So it was last year, when consumers depleted their savings. But that is the weakest kind of foundation for sustained growth and productivity. And when high and rising levels of economic activity, and fears of accelerating inflation are combined, we have a potent -- an almost explosive -- brew at work in the credit markets. So it was last winter.

These market strains and historically high interest rates -- as in the past -- had a strong impact on the more vulnerable sectors of the economy. Homebuilding, dependent on mortgage money, has been particularly hard hit. There have been strong incentives to reduce inventories -- generally a healthy reaction, but in this case aggravating the deeper-rooted problems of an auto industry struggling to adjust to a new mix of demand for fuel efficient cars. Small businesses, farmers, consumers, and -- not least -- savings bankers have felt the pain of higher costs of credit and, worse, uncertainty about its availability.

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It seemed clear to those of us responsible for monetary policy that there could be no easy escape from that pain through pumping up the supply of money and credit in an effort to keep interest rates down. The result could only be to confirm the very inflationary expectations that, in a fundamental sense, gave rise to the market strains in the first place. We would have been racheted to a still higher level of inflation, with still more fears of what the future might bring. The very groups in this country under greatest pressure -- the homebuilder and homebuyer, the smaller businessman, the financial intermediary locked into long-term securities -- would ultimately have the most to lose; instead of being able to look for a surcease from pressure, those pressures would be sustained. Then, as now, a policy course that seemed to point toward more inflation could only induce lenders to pull back from the credit markets in favor of current spending and more speculative outlets for funds.

Instead, as you know, in the past six weeks or so, market pressures have relaxed dramatically. The sharp decline in interest rates has demonstrably reflected a fall in the demand for money and credit, not an increase in supply. Part of the explanation undoubtedly lies in the decline in economic activity as consumers have attempted to restore their financial positions at a time when the homebuilding and auto industries were already depressed. But I suspect there has also been some tempering of the extreme inflationary fears so prevalent only a few months ago. That change in sentiment has been related to some degree to the stance of monetary and fiscal policy.

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It is in that sense that the linkage in the popular mind between monetary discipline and high interest rates, as an historical generalization, is simply wrong. Look around the world: it is the countries that have been most successful in curbing monetary growth and inflation that have the lowest interest rates. In Switzerland, to take the extreme, mortgage money in this inflationary age is still available at 4.15% and the money supply has been growing hardly at all!

The fact is the precipitous decline in interest rates in the United States has been accompanied by less monetary growth, not more. Indeed, the money supply dropped sharply in April. I am at least as suspicious as any of you about interpreting any single month's figures. We know that some technical factors probably helped account for part of the April decline; the data are, in any event, inherently volatile.

But, with all the qualifications, the point remains; money and credit growth have slowed appreciably. Indeed, there is now considerable room for growth, consistent with the targets we set for ourselves for all of this year -- targets that have been widely accepted as appropriate and consistent with reduced inflationary pressures over time. My point is that interest rates have not in any sense been "forced" lower -- nor will they be at the expense of excessive growth in money and credit, at the risk of a resurgence in inflation and inflationary expectations.

These are circumstances in which we can legitimately begin to look forward to dismantling the more direct measures taken in mid-March, some of which had their genesis in October of last year, to

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curb excessive growth in bank lending and consumer credit. The special reserve requirements and the call to confine growth of loans of individual banks within a simple guideline were and are clearly extraordinary measures, in important ways disruptive of normal market processes. We have not wanted to move prematurely -- we will not -- at the risk of false signals about our intentions to maintain control of monetary and credit growth. We want banks and other institutions during this critical period of transition to respect in their lending behavior the priorities reflected in the special program. But, equally, we are not interested in fostering any impression that credit allocation, formal or informal, can be any part of the basic continuing armory of monetary policy; the special measures are, to put it most simply, no substitute for general instruments of policy, and the side effects, if prolonged, can be counterproductive.

At the moment, it is evident that it is lower interest rates much more than any exhortations or controls that are beginning to play a constructive role in unlocking flows of funds to the construction industry and elsewhere. If sustained, those lower rates should, of course, restore the earnings and competitive position of the thrift industry, and enable you to resume your own accustomed role in financing.

The actual course of interest rates will, of course, continue to be influenced in the short run by the strength of economic activity and credit demands. Over time the Federal Reserve intends to provide the reserve base for orderly, restrained growth in money, consistent with unwinding inflation; our emphasis is not on a

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particular level of interest rates. And there must always be another caveat on the interest rate outlook: current or even lower interest rate levels can be sustained only if we, in fact, do make progress on the inflation front.

Given the inevitable and often long lags in response in the economy -- and the way some of the most popular price indices are computed -- it is simply unrealistic to expect unambiguous, dramatic progress toward price stability month by month in the period ahead. The methods by which the consumer price index is calculated can result in particularly misleading signals of current developments. Forthcoming data should be heavily influenced by two events that occurred in the first quarter -- the imposition of the oil import fee, which (if upheld in the courts) will soon affect the price of gasoline, and sharply higher mortgage rates. While few Americans purchased houses in the first quarter, and even fewer paid the interest rates posted by traditional mortgage lenders, it is those data that go into the index, with a heavy weight, as the commitments are taken down.

The last producer price index, rising at an annual rate of only 6 percent, just as surely overstates progress so far, for it reflected in part an exceptional decline in food prices. In my judgment, a more balanced view suggests there is indeed a reasonable prospect for a decline in the inflation rate to or below 10 percent before the year is out. But that can only be a first step -- and in some ways the easiest step -- on the road to price stability.

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Even that prospect is dependent upon avoiding another steep increase in the world price of oil. The chances of that occurring should, in theory and in practice, be markedly reduced by the evidence of some surpluses at present in the world supply of oil and by the relatively high stocks in consuming countries. But OPEC follows no iron law of economics. It is a measure of our vulnerability -- almost seven years after the 1973 episode -- that OPEC countries still have the potential market power to upset even a short-term forecast of relative oil price stability amid ample supply.

I will not dwell on the oil situation today, for you are as familiar as I with the needs and frustrations in achieving coherent and coordinated policies among consuming countries and a meeting of minds with the producers. There can be no denying the urgency of the problem from every point of view. It is that urgency that to my mind fully justifies the progress toward deregulation at home and the imposition of higher gasoline prices as a result of the oil import fee. In the short run, those policies may appear to impede the fight on inflation, for they do raise the price indices. But, in a larger sense, I firmly believe they help. Only as we are induced to conserve and reduce our dependence on OPEC sources of energy can we begin to feel more comfortable that our prospects and our stability will not be at the mercy of pricing decisions of others. Indeed, our energy vulnerability remains the greatest threat, alongside inflation itself, to our growth and prosperity.

The third problem I cited at the start -- the problem of productivity -- also poses hard choices and difficult dilemmas. Not all the causes and cures for our declining performance are clear. But, I believe the suspicion is well grounded that a failure of our

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capital stock to keep pace with the labor force, or to be renewed as rapidly as it might, is an important part of the problem.

That analysis leads directly to questions of the tax treatment of investment. The tax code, in my judgment, has for many years been biased against the savings/investment process. There is no absence of proposals for reform in that area. But we also have to recognize the hard reality that all the proposals have a common characteristic -- they lose revenues for at least a period of time. Consequently, we cannot escape the matter of budgetary priorities -- or, at least for a time, acquiesce in still more deficit spending.

You ladies and gentlemen are responsible for private financial intermediaries, looking to individuals for savings and passing those savings along to homebuyers and others. You compete with a variety of institutions -- and the most overpowering of those can be the Federal Government itself when it comes into the market for tens of billions of dollars; market congestion or not, low interest rates or high, its needs will be satisfied. That was, of course, precisely what happened last winter, when market pressures were at their greatest.

The plain lesson is that one contribution the Federal Government can and should make to capital formation is to avoid preempting so large a share of the available credit, year in and year out, as has been the case in the past decade.

At the same time, we know taxes are too high for the sake of economic growth and investment. Carefully constructed tax reform and reduction can be an ally -- indeed, it may be an

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indispensable ally -- in the effort to restore productivity and to sustain growth. I yield to no one in my conviction that intelligently constructed tax reform and tax reduction -- addressing the problems of investment, productivity, and costs -- is sorely needed.

But we can't simply wave away the budgetary constraint or questions of timing. And that timing seems to me, like it or not, dependent on progress in reducing the rate of expenditure growth, reductions not just in Administration planning or in initial budget resolutions, but reductions that are signed, sealed, and delivered!

Only a few weeks ago, under the pressure of credit market strains and inflationary fears, a broad consensus developed in the Congress and without about the importance of cutting proposed spending and balancing the budget. I believe that is still the prevailing mood. But there is an obvious danger that the consensus could fracture in the face of apparently discouraging business news and the reduced level of interest rates.

I am not so concerned about one contingency that arises in any budget planning -- that a major recession, should it develop, will result in lower revenues than projected. Such an outcome would imply a very slack economy, some reduction in other credit demands, and only temporary implications for revenues. What would gravely concern me would be to turn away from spending restraint and budgetary balance as a matter of deliberate policy. In the short-run, the effects on financial markets so sensitized to

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inflation concerns and, after decades of deficits, increasingly skeptical of budget planning, could only be counterproductive. Equally important over time, failure to carry through effective expenditure restraints -- reducing the proportion of the GNP absorbed by government -- can only undermine the case for, and opportunities for, the tax reduction we need.

I recognize the uncertainties in the business outlook as the budget is debated. But inescapable uncertainty is not in my mind synonymous with -- a euphemism for -- gloom about the course of the economy. I know of few economic analysts, in or out of government, that can take much satisfaction from his forecasting record during recent years; to commit ourselves today to policy options that would make sense only if the worst happens is at least as likely as not to be counterproductive.

Let us not be oblivious to the real risk that the rather sharp decline in consumer spending over the past two months, coming on top of the already serious problems of the auto and housing industries, could precipitate further spending adjustments. But let us be conscious, too, of the strong possibility that housing could be approaching its low point, with a considerable backlog of demands that will become effective as the credit markets open up. The auto industry is bringing smaller cars on line, and larger models available today may turn out to be a bargain as their production is phased down. Exports -- a larger sector than housing -- are doing well. Inventories -- barring a cumulative downturn -- are not oppressively high.

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It's inherently, as usual, a mixed picture.

What we can know with certainty is that inflationary sensitivities and pressures remain high -- and we no longer have a realistic option of inflating ourselves out of recession. The mere effort could only be destructive of the chance for restoring orderly credit flows at reasonable interest rates.

We can also be sure that the need for energy conservation and production is essential to our stability. And we know that, in the end, we will need to improve productivity to support economic growth and to help wind down inflation.

It is these three areas -- inflation, energy, productivity -- that must remain the continuing focus of policy making.

I see no inconsistency with the new concern about recession. I would indeed go further. Without progress in these areas, efforts to deal with recession will ultimately be doomed to failure.

This has been for me a rare opportunity to speak to savings bankers in convention assembled. I am conscious that I have only touched in passing on the urgent problems -- short and long-term -- of your industry. I am, of course, well aware of the wounds left by recent developments. The healing process has just begun, and your stake in maintenance of orderly credit market conditions -- and in the priority given to the attack on inflation -- is obvious.

In the best of circumstances, I suspect you already realize there can be no simple retreat to "business as usual." The inherent risks of borrowing short and lending long in an uncertain world have been freshly exposed, and you will need a better balance among your assets and liabilities. New lending powers, new mortgage

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instruments, new forms of deposits can all make a contribution, and will need careful study and experimentation.

I am sure you have no illusions about the strength of competitive forces. Those of us responsible for regulation of the interest rates you pay (I perhaps would be more accurate if I said responsible for the deregulation of those rates) are hard at work. We are, of course, looking at the immediate situation and at today's needs partly in the context of what approaches make sense in the light of the ultimate objective of decontrol. I can't promise our decisions will always make your life any easier -- but I think I can promise it will be an interesting time for all of us as your industry and others gradually move away from regulatory domination of the interest rates you pay.

I am conscious, too, that you and we in the Federal Reserve will have to become accustomed to living more closely together as portions of your business become subject to reserve requirements. From my perspective, that's not all bad -- but I know tastes vary in that respect!

Where I hope our views will always closely coincide is in the endless battle for disciplined, consistent financial policies for our country. In the last analysis, that is the only environment in which we both can do our job well.

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