

For use at 6:30 PM E.S.T.
Wednesday, December 3, 1980

A Rare Opportunity

Remarks by

Paul A. Volcker

Chairman, Board of Governors of the Federal Reserve System

before the

43rd Annual Dinner

of the

Tax Foundation

New York City

December 3, 1980

I am honored and grateful in receiving the Public Service Award of the Tax Foundation, a group that through the years has done so much to encourage dispassionate study and analysis of critical aspects of public policy. I must confess that upon first being approached about this occasion, it struck me as anomalous that, with all the debate and rethinking about tax strategy now going on, the Tax Foundation turned to a man principally concerned with monetary policy. But perhaps it's appropriate that we not get into the details of tax policy this evening.

Any incoming Administration needs the opportunity to fully develop and present its specific proposals in the context of a comprehensive, long-term, coherent economic program at a time of its choosing. Little can be gained, and much can be lost, in developing the necessary policy consensus and support by gratuitous speculation by others about the precise shape of the proposals before they are made.

Obviously, the same strictures need not apply to a discussion of monetary policy. Moreover, the monetary and financial environment provides an important backdrop in any consideration of the fiscal and other critical economic issues that face the nation.

At the very outset of my remarks, I want to emphasize two points.

First, I believe we have a rare opportunity in the months immediately ahead to come to grips, in a fundamental and decisive way, with the inflationary problem that lies at the heart of so much of our economic malaise. One dimension of that opportunity lies in the widespread public appreciation of, and concern about, the inflation problem. The political dimension is inherent in the taking of office of a new Administration and a new Congress, seized with a sense of urgency, with energy and with new ideas. And I am convinced the intellectual dimension will not be lacking; the main outlines of necessary and appropriate policies can be reasonably distilled from elements of thinking common to most of the leading schools of economic thought.

My second point seems to me at least as important. Let us not be beguiled into thinking there are quick and painless solutions to a set of economic problems that have been decades in the making, that in greater or lesser degree have become endemic to Western industrialized nations, and that grow out of deeply ingrained public and private policies, attitudes and expectations. Success will have an enormous payoff in rebuilding a solid foundation for growth and prosperity. But it cannot be achieved by a nation pulling back from hard choices.

In emphasizing the central nature of the inflationary problem, I do not suggest that inflation is our only problem. Nor would I claim that unemployment, declining productivity, low savings and investments, energy dependence, points of strain

in the domestic and international financial fabric, and the weakened competitiveness of some industrial sectors will somehow all smoothly recede as we successfully deal with inflation. To the contrary, those problems in some instances have specific causes and have themselves significantly aggravated inflationary pressures; each will need to be approached and dealt with on its own merits.

What I would suggest is that the inflationary process is today, as one wise man has said, more than the sum of those separate parts. With all its built-in momentum and self-sustaining expectations, it has come to have a life of its own, and the distortions and instability it breeds undercut all our efforts to deal effectively with the more specific problems.

I am, of course, aware of the concern or perception that a frontal assault on inflation can in the short-run (and we all live in a succession of short-runs) threaten other aspects of economic performance or our sense of well being. We tend to associate monetary and fiscal restraint with low growth and productivity and with high unemployment and interest rates. Moreover, after decades of inflation, many of us, more or less comfortably, have adapted our business and personal lives to the prospect of more inflation. We count on capital gains from inflating house and land values as a substitute for real savings. We assume our competitors will match our aggressive pricing policies, and will also accede to high wage demands. We take comfort in our purchases of precious

metals, art, and more exotic "collectibles" -- or envy those who did buy -- and are tempted to project essentially speculative price movements into the great beyond.

But none of this sense of accommodation to inflation can be a valid excuse for not acting to deal with the disease. Experience amply demonstrates that years of temporizing in the presumed interest of sustaining growth, productivity, and employment have borne bitter fruit instead. We find ourselves with more inflation, more unemployment, and less growth. The fact is the idea of a sustainable "trade off" between inflation and prosperity, however valid in particular circumstances for a time, broke down as businessmen and individuals learned to anticipate inflation, and to act on this anticipation. Indeed, expectations sometimes seem to me to run ahead of the reality. The result is that orthodox monetary or fiscal measures designed to stimulate can potentially be thwarted by the self protective instincts of financial and other markets.

Quite specifically, when financial markets jump to anticipate inflationary consequences, and workers and businesses act on the same assumption, there is room for grave doubt that traditional measures of purely demand stimulus can succeed in their avowed purpose of enhancing real growth for any significant period of time. And it seems to me a certainty that, whatever the short-run effect, we would be left in the end with still more difficult dilemmas -- still more congestion in credit markets and still higher interest rates; still less incentive

to save; and still more of our citizens preoccupied with beating inflation rather than with efficient production.

If the public instinct is right that beating back inflation is the first economic priority, I cannot escape the corollary that monetary policy has an essential role to play in that process. I do not intend to linger tonight over the intriguing questions about how best to define money and to control it, precisely how fast money and credit should grow consistent with a return to price stability, and how much weight should be given to each of the various money measures or to interest rate stability. Those issues are likely to remain matters for debate among specialists. But I do want to be unambiguous about the basic point: no anti-inflationary program can be successful if monetary policy stands ready to accommodate passively, through the process of money and credit creation, whatever financing demands flow from the inflationary process. Put more positively, the Federal Reserve must act, as best it can, to contain persistently the growth of money and credit, by controlling its supply, to amounts commensurate with a return to price stability.

How fast, by what methods, and over what time period, may be matters of judgment. In the midst of economic turbulence, some volatility in money growth may be inevitable over short time periods. But it seems to me analytically beyond doubt that the job of restraint can be done over reasonable time

frames and within the necessary limits of precision, and that the job must be done if we are to deal with inflation.

The relevant question is at what cost in terms of other objectives. The answer to that question will not be determined by monetary policy alone, or even primarily. A central bank does not control, or directly influence, the demand for money, or how much of the available supply of credit is used to finance real growth and investment as opposed to the turnover of goods and services at higher prices. Put another way, within a broad range, restraint on the supply of money sets limits on the growth of the nominal gross national product. Whether that nominal growth is absorbed by inflation and public spending, or whether real growth in the private sector can proceed, will depend in large part on other policies and attitudes, public and private.

Recent experience illustrates the problem. Growth in the various money measures is currently running close to or slightly above the upper edges of the ranges we set for ourselves at the start of the year; measured against our stated intentions (intentions that were widely thought appropriate) we have not been unduly restrictive. Yet, in real terms, the GNP actually fell slightly over the course of 1980. The sizable growth of almost 10 percent in the nominal GNP over the same period was swallowed up by inflation.

I take some satisfaction, limited as it must be, from the fact that the almost explosive inflationary pressures early this year, associated in part with the oil price increases, were contained and diffused; the fears that inflation would accelerate sharply were not borne out. But I need not emphasize that 1980 has been a difficult year, marred by recession and rising unemployment and depressed activity in key industries. Moreover, in recent weeks and months, as an otherwise welcome and surprisingly strong revival of business activity has generated sharply increased demands for money and credit, we have had to lean increasingly hard on the supply of bank reserves to slow excessive money growth. Combined with the effects of large deficits and continued strong inflationary expectations, the credit markets are again under heavy pressure, raising renewed and understandable concern about the sustainability of the recovery.

In these circumstances, an intellectual consensus rightly remains that the growth of money and credit must continue to be curbed in the interests of encouraging price stability. This is our intent and purpose. But that does not dispose of the question -- given the apparent inflationary momentum -- about the extent to which the restraint necessary to curb inflation will, in the short-run, squeeze out real growth as well. That will, in the end, depend upon the speed with which we can make progress on inflation.

Inflation persisting at around 10 percent -- the current rate of the GNP deflator -- in 1981 would imply nominal GNP growth of, say, 12 percent or more if we are to have significant real growth. Is that nominal growth consistent with an increase in the narrowly-defined money supply on the order of 3 to 6 percent, or in the broader aggregates of 6-9 percent, our tentative targets for 1981?* Years of research and seemingly endless computer simulations have not identified relationships among nominal GNP, money, interest rates, and other variables so close and unvarying, particularly for periods as short as a year, as to permit a certain judgment. But the likelihood of a squeeze is apparent; we see a taste of it now. The essential purpose, of course, is to squeeze out inflation, not growth.

*These figures represent an average of target ranges for 1981 tentatively set by the Federal Reserve in July, abstracting from the distorting effects on M-1A and M-1B from the introduction of NOW accounts -- in effect interest-bearing checking accounts -- on a nationwide basis at the beginning of next year. Tentative targets for M-1A and M-1B were set 1/2 percentage point lower than their 1980 ranges of 3-1/2 to 6 percent and 4 to 6-1/2 percent, respectively. It was recognized at the time that the introduction on a nationwide basis of NOW accounts would distort measures of these aggregates by causing shifts of funds out of demand deposits and other assets into NOW and similar accounts. A crude tentative estimate was that, consistent with the above targets, such shifts might reduce growth in M-1A to 0 to 2-1/2 and raise M-1B to 5 to 7-1/2 percent. Growth ranges for 1981 for M-2 and M-3 were set at 5-1/2 to 8-1/2 percent and 6-1/2 to 9-1/2 percent, respectively.

In a purely arithmetic sense, if the inflation rate begins to decline appreciably, there should be room for significant real growth. But the economic question is more relevant: what can we do, as a nation, to maximize the progress against inflation, in the process relieving pressures on financial markets and enhancing prospects for an early resumption of sustained growth.

One prominent element in recent discussions has been to note the potential importance of expectations in this respect. Certainly, expectations, as they are reflected in wage bargaining, in pricing policies, and in financial decision-making, have in the past few years both fed the inflationary process and tended to increase pressures on financial markets. To the extent those expectations can be changed -- to the extent that the safer bet and the wiser money begins to anticipate lasting progress against inflation -- the easier our job will be. Our own sense of conviction in restraining money -- and even more a demonstration of success measured realistically over a reasonable period of time -- will be among the crucial ingredients in changing those expectations.

But I don't want to encourage unrealistic hopes. Expectations grow mainly out of experience over a considerable period of time. It took years of gradually rising levels of inflation for behavior to change importantly; now inflation is institutionalized in three-year wage

contracts, in enormous built-in resistance to price declines in many economic sectors even in slack markets, in widespread indexing and public policies designed to protect the competitive positions and incomes of those sectors with political power, even when productivity performance cannot support that protection.

At this point, skeptical Americans are all too likely to claim Missouri residence; they will want to be shown that policies adequate to the job will not only be proposed, but they will be sustained, and will be sustained through near-term difficulties, before the established behavior patterns are broken. And I sincerely question whether monetary policy by itself can or should be asked to carry the entire load.

I know that, in concept, a case can be made that restraint on money and credit alone, sustained long enough and strongly enough, could control inflation, and thus lay the ground for renewed growth. But is that a realistic, tolerable, believable course if other instruments of policy and opinion are running counter to our purposes? Will the sustainability of the policy be credible if the costs in growth and employment seem excessive, and the costs fall unfairly on the industries and elements of the population most dependent on credit?

Surely, the prospects for success will rest on visible evidence that policies across the board are moving in a

coherent and mutually reinforcing way. Then, indeed, the potential collision between monetary restraint and growth will be minimized and expectations will, sooner rather than later, turn in a more constructive direction.

One of my distinguished predecessors, Arthur F. Burns, distilled into a lecture after leaving office some of the key lessons of the inflationary experience. The title, "The Anguish of Central Banking," understandably struck a responsive chord with me. The central theme was both profound and simple. For decades, in this country and elsewhere, a maze of governmental policies and private practices have developed aimed, with considerable success, at stabilizing incomes and employment and protection against market pressures, in the process adding to the responsibilities, costs and taxes of the Federal Government. The goals are worthy and continuing. But one result has been to eliminate or dampen some of the natural flexibility and balance of the market economy, and to impart a strong inflationary bias to the system by an upward ratcheting of prices.

I need not elaborate the analysis here. We cannot and should not turn our backs on valid goals. But I would suggest the relevance of reexamination of all those regulatory and other policies that do add importantly to costs and prices, that induce rigidities in wages that may be counter to the long-run interest of workers themselves, to see if the essential objectives cannot be met in more effective ways,

or at less cost. Equally important and certainly feasible, we can resist those efforts -- present today and virtually every day -- to stake out new areas of protection from normal market pressures, whether those competitive pressures originate at home or abroad.

The list of entrenched rigidities is formidable; each is defended by tenacious interests. No single reform is crucial, and the temptation is therefore strong to "leave it to the other fellow." But it is crucial, in the common good, that we face up to the task. And, indeed, in a few areas, a fair start toward deregulation has already been made.

I have left fiscal policy to the end. I will be brief because my point can be made succinctly, not because the fiscal dimension of our policies is in any way subsidiary. Indeed, the pending fiscal decisions will send the strongest kind of message to the American public, and the substance can have a critical impact on the performance of the American economy and the financial markets.

It has been rightly said that "well-structured tax relief can have important favorable effects on incentives, on investment, and thus ultimately on productivity. But before I join the 'taxpayers revolt' in the name of anti-inflationary policy, I must emphasize the necessary corollary. We cannot proceed without concern about the size of the deficit. Prudent tax reduction, in the end, depends on expenditure restraint."

Those last four sentences were taken directly from a speech I made in 1978. Events since then have only reinforced the case for tax reduction; it is a powerful one.

But events have also confirmed the difficulties of expenditure control; I remind you of the earnest efforts of the current Administration and Congressional leaders to that end earlier this year. There is no area in which the new Administration and the Congress will more need your sustained support.

I am encouraged to believe the necessary understanding and will is growing. That is a key ingredient in the great opportunity to which I referred at the start of these remarks -- the opportunity to deal forcefully with inflation and to restore a solid base for economic growth.

To capitalize on that opportunity, the Federal Reserve for its part intends to maintain the restraint on money and credit growth needed to wind down inflation. But, monetary policy should not alone be called upon to deal with inflation, for the risks and costs would then be far greater than necessary. We need a total effort -- a demonstration that all the major instruments of economic policy are moving in a coherent and mutually reinforcing way. Then, we can indeed turn expectations and reality in the direction of price stability, have solid grounds for anticipating reduced pressures on financial markets, and in the process enhance the prospects for growth. I look forward to working with the new Administration and the Congress toward that result.

* * * * *