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No Time for Backsliding

Remarks by

Paul A. Volcker

Chairman, Board of Governors of the Federal Reserve System

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I am delighted to be back at the Press Club again, most particularly during the tenure of Joe Slevin as your President. He has the deserved reputation of knowing as much about what the Federal Reserve is doing as we do ourselves -- and sometimes I fear he is even a little ahead!

In any event, I think I can take it for granted by now that all of you are familiar with the basic premise of our monetary policy -- that a lasting solution to our economic problems of slow growth and poor productivity performance, of exceptionally high interest rates and severe strains on credit-sensitive sectors of the economy, is dependent on success in the fight against inflation. We have begun to see scattered signs of progress -- a beginning. But the battle is far from won -- indeed, I believe we are just entering the crucial stages.

As we do so, let's be clear about what is at stake, and realistic about what's required for success. We are dealing with an inflationary momentum, and patterns of thinking and behavior, that have developed over decades. Something like half the working population -- those under age 35 -- have never known price stability in their working experience. During that period, we have seen repeated attacks on inflation, launched with sincerity and real concern -- but, unfortunately, we have also seen those efforts fail in whole or in part when they seemed to conflict with other objectives. We have become accustomed to living with inflation, adjusting to it -- and anticipating more. And as we have done so, we unwittingly set in motion forces that have kept it going.

Against that background, skepiticims and doubts about the current effort are understandable. But there are differences today -- differences that I am convinced will make a crucial contribution to success.

Most importantly, the experience of the 1970's demonstrates unambiguously that inflation is destructive of our economic goals of stronger growth in real incomes, productivity and employment. No longer do we hear the argument that a little inflation can be a kind of pep pill for the economy; instead, an addiction to pep pills in the economy, as in personal health, can only ultimately lead to a sense of disorientation and despair. As a corollary, there is broader understanding of where our priorities-must be today if we are to lay the foundation for a prosperous 80's. After all, we face the strains we do today because earlier efforts to deal with inflation were half-hearted or not sustained. Today there is greater reconition that failure to carry through now in the fight on inflation will only make any subsequence effort more difficult, at much greater risk to the economy.

> And finally, we have come a long way in putting in place the essential elements of an effective program to deal with the problems. To be sure, important elements in that program still need to be implemented. In political terms, those elements may be among the most difficult. In economic terms, the evident strains, pressures, and pain in some sectors of the economy try our patience. But I also believe the American people recognize that the problems of decades cannot be cured overnight; that we, in fact, have now the opportunity to change direction if we only stick with it.

One crucial element in "carrying through" is persistence in monetary policy -- continuing to bring down excessive growth in money and credit to the point where the supply of our dollars does not outrun the supply of real goods and services.

When I last spoke to the Press Club, I was inevitably in a position of talking more about our intentions than our performance. At times over the past two years, the money supply and interest rates have fluctuated sharply, sometimes raising doubts among the legions of Fed watchers whose professional life is to scrutinize -- and provide instant analysis of -- the latest financial news. But with the perspective of time, I also believe there is now ample evidence that we mean what we say, that the trend of monetary and credit growth is slowing, and that our purposes are clear in our actions.

There are a few who would be inclined to say that is enough -- that sooner or later reduced monetary growth will cure inflation, and little more need be said on the subject. And that is, indeed, one textbook model. But it is far too limited a model to capture today's reality.

The inflationary process, after continuing for years, is embodied in a whole pattern of economic, social, and political behavior that tends to sustain -- and accelerate -- its own momentum. We see the process at work in the pattern of three-year wage bargaining, building in rising levels of costs into the future; in aggressive pricing policies, justified by the proposition that everyone is doing it; in attempts to protect one's own position by indexing, usually to a consumer price index that is itself distorted; in demands for inflation premiums in financial markets and interest rates; in the search for inflation hedges in real estate or elsewhere. To be sure, starving the inflationary process by restraining money and credit long enough can ultimately curb that behavior -- and there are signs it is beginning to do so now. But to rely on that course <u>alone</u> would surely delay the process of correction, and pose more risks and exact more pain than a balanced approach.

Do not misunderstand me. Restraint in growth of money and credit must be a cornerstone of successful policy -- without it the anti-inflation efforts would fail. Monetary policy has a heavy -- and inescapable -- responsibility. We mean to discharge that responsibility. At the same time, let us, as a nation, recognize the logical consequences if monetary restraint is not supported and complemented by other policies.

Today, we face extraordinarily high interest rates. Those interest rates are a particularly heavy burden on credit-dependent sectors of the economy -- the homebuyer and builder, the car dealer, many small businesses and farmers. Financial markets are distorted, bond financing impaired, and part of our institutional structure under heavy strain. Other sectors seemingly are able to shrug off high interest rates, at least for a time -- the rapidly expanding energy sector, high technology and defense industries, to take some examples. And, of course, Federal borrowing continues unabated.

Interest rates are ultimately set in the market -- by individuals and businesses acting upon their own judgments of their current needs and the future. The influence of the Federal Reserve on interest rates is limited and short-term -- except as our policies bear on the future course of the economy and inflation. If anyone still doubts that proposition, look at market developments in recent months. Viewed broadly, the money supply has been under satisfactory control in terms of our basic policy objectives of restraint. In those circumstances, and consistent with the operating techniques I discussed with this group last year, pressures on bank reserve positions have been less intense in recent weeks. The most sensitive short-term interest rates are well below their peaks, by 2½ percent or more. Yet, bond rates and mortgage rates during the same period reached new peaks, and the prime lending rate of banks has subsided only a bit. Clearly, the markets have been preoccupied with other concerns -- including the current and prospective volume of financing and questions about the longer-term inflation outlook.

It would be fruitless and wrong to think those pressures can be relieved simply by pushing more money into the system than called for by our basic objectives. Whatever temporary effects there might be on money markets -- and even they are problematical -- we would gain nothing if we induced more concern about inflation. The ultimate result would only be to stimulate more borrowing and to increase the reluctance of lenders to accept lower interest rates. We can indeed increase money and credit in nominal terms; we cannot, by simply manipulating the tools of monetary policy, increase the pool of real savings from which real investment and housing must ultimately be financed.

What we as a nation can do is to relieve the pressures on the market from the Federal deficit -- and in the process both reinforce the fight on inflation and lighten the burdens on the most vulnerable economic sectors.

Less than two months ago, the Administration and the Congress adopted a far-reaching fiscal plan, designed to reverse the trends of the previous decade. One major element in that plan is in place, a stabilization and reduction of the Federal tax take relative to national income. The justification for those tax cuts lies in the promise of improved incentives for businesses and individuals alike for investment, savings, work, and productivity.

But, of course, the cuts involve large revenue losses in the years immediately ahead. In recognition of that, a sizable swipe has been taken at the rapidly rising trend of government spending -- seemingly so inexorable during the 1970's. That effort, as I have noted on many occasions, exceeds anything I have seen in my Washington experience. But the hard fact is that, as the President emphasized last night, it goes only part way toward fulfilling the fiscal plan, aimed at balancing the budget in 1984. And it has been doubts precisely on that score that lie behind much of the financial market skepticism and behavior.

To illustrate the point, let me give you a few numbers. This year, the Treasury will finance directly about $80 billion, $60 billion or so of budget deficit and $20 billion or more of "off-budget" programs. We will generate about $170 billion of net savings. So the Federal Government will itself preempt about half of what is available to add to our capital stock, to inventories, or to housing. Is it any wonder, under the circumstances, that the homebuyer or the small businessman feel "crowded out"?

Of course, there is no simple co-relation between deficits and inflation, or deficits and interest rates. The significance of a deficit in any particular year depends upon the state of the economy -- including particularly our savings potential and competing demands for credit. For instance, Japan and Germany, to take two examples, have been able to finance much larger budget deficits relative to the size of their economies, and more investment too, because their savings rate is a multiple of our own. But the hard fact is that our savings are limited -- and we are in effect leaving the most vulnerable sectors of the economy with the crumbs from the national economic table.

The need for further spending restraint has been explicit in the Administration's expenditure projections all along. The President has now outlined some of the further actions necessary to close the budgetary gap, and emphasized that "holding down spending must be a continuing battle for several years to come."

That, it seems to me, is the challenge the Administration and the Congress set for themselves in enacting the tax legislation. In the nature of things, to meet that challenge requires action now. Any failure to do so has inevitable consequences for conditions in credit markets or for taxes, or both -- and for the success of the whole economic plan.

There is another challenge that must be met in moving toward price stability. How fast and how smoothly that process proceeds -- in the interest of all of us -- will be related critically to the rate of productivity and wage increases, recognizing that labor costs account for some two-thirds of all costs in the economy.

Let me put the point in the context of monetary policy. Restraint on the supply of money and credit implies some rough ceiling on the dollar value of transactions that can be financed --

reflected in the nominal GNP. The relationship is loose, because the velocity of money turnover can, of course, increase, as it has been. But, beyond a certain point, that process is normally accompanied by high interest rates and pressures on financial markets that restrain economic activity.

The aim of policy, of course, is to dampen inflation, not real growth. But monetary policy alone is a blunt tool; the risks in the short-run of affecting real activity increases as the upward momentum of costs continues.

I alluded earlier to the signs of progress on the inflation front. But I would be less than frank if I failed to point out those signs have not yet been confirmed by clearly visible and significant progress toward wage deceleration. The evidence this year is ambiguous. We can indeed find signs of restraint in some areas, but we see other areas where a kind of "business as usual" attitude prevails, building past inflation trends into future contracts.

1982 will be a crucial period in this respect. Unlike this year, it is a major bargaining year for pattern-setting industries, beginning with refinery workers and truckers and running through the auto industry in the fall. There is no escape from the reality, paradoxical as it may appear, that the prospects for sustained economic growth and increases in real wages for **all** Americans will improve as we achieve greater productivity and moderation in the demand for nominal wage increases. It is at that point that the signs of progress against inflation are reflected more solidly in underlying cost trends that confidence in the success of the entire effort is likely to strengthen enormously. Those are the conditions in which we could look forward to combining reduced inflation with strong growth and favorable financial market conditions.

We can not achieve that result by government fiat. But we can -- indeed, we have the clear responsibility to -- conduct public policies in a way that encourages understanding of what is at stake. We can emphasize that, when growth in nominal GNP is limited by monetary and credit restraint, large cost increases could eat up much or all of the available dollars, leaving little or no room for real growth. That may seem an abstraction, but in the concrete it can be translated into the risk of profit and job loss for those industries leading the pack in costs and prices.

The fact is a conflict may be brewing between high nominal wage expectations and economic policies needed to curb inflation. It might be argued that conflict could be resolved by creating money and more inflation -- but only at the expense of a more severe dilemma next year, and the years beyond. The result would be less growth and lower real incomes. That cannot be a responsible answer.

What we can do, and do entirely consistent with our basic commitment to free markets and competition, is to make clear that markets will be permitted to work, that governmental impediments to competition will be reduced, not increased; and that costly governmental rescue operations are not the answer. Perhaps the greatest force for competition and discipline lies in open markets internationally -- and every retreat from that principle sounds a signal that makes the job of fighting inflation harder. Right at home there is a full agenda as well, repealing or relaxing that host of regulations and regulatory policies that impede competition and add unnecessarily to costs.

In sum, we are in the midst of dealing with the accumulated problems of decades. It is inevitably a painful process -- precisely because it has been put off so long. But the battle is fairly joined; we can already see glimmerings of progress; and to procrastinate now would only be to amplify the pain later.

As things stand, it is a fair point that monetary policy carries too much of the burden -- that the consequence is more strain and pressure on financial markets and credit-dependent sectors of the economy than is desirable or would otherwise be necessary. But surely it would be no remedy to breech the monetary dike, and flood the economy with more inflation.

Rather, the answer will be found in supplementing monetary restraint with other actions -- actions that will both speed progress against inflation and set a firmer groundwork for growth. Major parts of that program are already in place -- and the rest entails no change in philosophy or thrust from what has already been said.

As the President emphasized again last night, what is required is action -- particularly action to reduce the deficit and move toward budgetary balance. We need to carry through on regulatory impediments to cost reduction. Perhaps as important, we also need to resist pleas for new protection.

These are the elements that are crucial to success. They obviously involve a certain amount of patience, a clear-eyed realization of what is at stake, a recognition that there is no "magic pill" to blissfully transport us suddenly to the promised land of stability and growth.

But that land does exist -- and I am convinced we are moving toward it. This, it seems to me, is no time for backsliding.

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