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Remarks by

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Caperton Lecture

Owens Graduate School of Management

Vanderbilt University

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I am delighted to be here at Vanderbilt University and to deliver the Caperton Lecture. My talk today focuses on what I believe must be a wide-ranging attack on the Nation's primary economic problem -- inflation. I am convinced that success in this effort is fundamental to solving our longer-range problems of slow growth and poor productivity. While we have begun to see signs of progress in recent months in the form of some easing in a number of price measures, the battle is far from won. Indeed, I believe we are just entering the most crucial stages.

As we explore this issue, let's be clear about what's 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 and consuming lifetimes. In the circumstances, it's perhaps understandable that so many have come to "count on" inflation -- pricing policies, salary demands, financing patterns and investment behavior have all come to be set on that assumption.

At times, we have seen efforts to combat inflation, efforts launched with sincerity and real concern. Unfortunately, we have also seen these efforts defeated, or abandoned, in whole or in part when they seemed to conflict with other objectives. The whole inflationary process gained momentum in the mid-1960's when, as a nation, we tried both to fight a war and introduced a "great society" without facing up to its cost. Policies of

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restraint in the late 1960's were not pressed for long. By 1971 we turned to mandatory wage and price controls. The apparent gains from that program were washed away in good part because our fiscal and monetary actions were not adequately disciplined. There were later examples of policy responses to inflationary concerns, but the hard fact is they were not pressed long enough or hard enough to turn the tide. Instead, the conviction grew that each cycle of economic activity would leave us with a residue of still higher prices.

But it was also true that, by the late 1970's, the costs were becoming more apparent. Inflation, after it has been around awhile, tends to feed on itself -- the expectation of inflation, strongly enough held, produces behavior that perpetuates and accelerates the process. As that happened, the effects -- in higher interest rates, in reduced emphasis on productive activity and more emphasis on speculative activity, in lower productivity -- became noticeable. And a lot of people also noticed that, contrary to much earlier doctrine, as inflation continued, unemployment tended to rise and economic growth to slow.

I believe over the past year or more we can sense a growing commitment among the American people that the time has come to deal decisively with inflation. And I believe there is a realistic appreciation that sudden, painless solutions are not possible, but that failure to face up to the job would ultimately entail much heavier costs.

Economists, too, have begun to realize that a little inflation is not always a good thing -- a benign kind of "social solvent" useful in resolving competing claims on a limited amount

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of real output. Instead, they now recognize that the efficiency of our economy is impaired by our inability to distinguish relative price changes from movements in the overall price level, by the greater uncertainty about the future course of price changes, and by the loss of our most important financial yardstick--a stable dollar. And, when inflationary expectations are high, adding extra money to the economy--rather than promoting growth and real activity--may simply inflame the inflationary process.

Building on that understanding, I believe we have come a long way in putting in place the essential elements of an effective program to deal with inflation. To be sure, much remains to be done to implement that program. In political terms, those elements--especially carrying through on spending restraint--may be among the most difficult. Meanwhile, the strains, pressures, and pains in some sectors of the economy are only too evident. The extraordinarily high interest rates we face today are a particularly heavy burden on the credit-dependent sectors of the economy--the homebuyer and builder, the car dealer, and many small businesses and farmers. Financial markets are distorted, bond financing is impaired, and part of our institutional structure is under heavy strain.

At the same time, we can see some signs of progress. We can see the beginnings of a change in direction--and if we persevere, recognizing that the problems of decades will not be cured overnight, we can lay a solid base for a prosperous 1980s.

One crucial element in "carrying through" is persistence in monetary policy, and that, quite naturally, is where I turn

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first. Economic theory and historical experience alike support the proposition that inflation will not subside unless we restrain the growth of money and credit over time to amounts consistent with the potential growth of real output at stable prices.

As many of you know, the Federal Reserve two years ago adopted new operating procedures in order to focus our control more directly on the growth of money. Those procedures place emphasis on the growth of bank reserves, which in turn is related to growth in money and bank deposits -- particularly so-called transaction balances, measured by M-1. While many other factors have influenced markets, that change probably contributed to more volatility in short-term interest rates, particularly in 1980. At times, the money supply has also fluctuated sharply. A good deal of volatility in the money supply from month-to-month and quarter-to-quarter is probably inevitable, and should not be of consequence. Of course, there will always be debate about the significance of the most recent data and whether the Federal Reserve is leaning marginally too hard in one direction or another. Today is no exception. For instance, there are questions as to which monetary aggregate is the best indicator of policy at the present time, the extent to which financial innovations are changing the money-holding patterns of Americans and the like. The answers to these questions, in the end, are matters of judgment.

I will not take the time now to review all the evidence, but I will assert that viewed over a reasonable period of time, there is now a firm basis for concluding that we mean what we say -- that we are bringing down the growth of

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money and credit. Moreover, I believe that this approach commands broad support as a crucial element in anti-inflationary policies.

Moreover, as I suggested earlier, we can now begin to see signs of progress in the fight against inflation; the rates of increase in most overall price measures have slowed over the past year. But we have also seen exceptionally high interest rates -- far higher than consistent with a strongly growing economy -- and, in recent months, a sluggish economic picture overall.

All of this emphasizes that, while slower growth of money and credit must be a cornerstone of a successful anti-inflation policy, the process will be unnecessarily painful unless monetary restraint is supported and complemented by other policies. One clear priority in that respect must be to relieve the pressures on financial markets from the actual and anticipated federal deficits -- no other action would go so far toward reducing the burdens on our most vulnerable economic sectors.

Only a few months ago, the Administration and the Congress adopted a far-reaching fiscal plan, designed to reverse the trends of the past decade. Over the last 10 years, federal outlays have increased from 20-1/2 percent of our GNP to over 23 percent, and government revenues have shown a comparable rise. Three percent of our GNP may not sound so large, but it is equivalent to almost $90 billion -- more than our spending for new cars this year. The increase in effective tax

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rates that characterized the last decade understandably met with resistance, not just politically, but in terms of impairing economic incentives and efficiency.

In response, an enormous tax reduction program has been put in place, extending over a number of years and promising improved incentives for businesses and individuals alike for investment, savings, and productivity. That can obviously be constructive -- providing the loss of revenue does not entail massive and continuing deficits. Under those circumstances the positive beneficial aspects of the tax program would likely be undercut by recurrent strong pressures on credit markets and interest rates, a sluggish economy, or both. We have had a taste of that in recent months.

I recognize that when enacting the tax cuts, the Administration and the Congress also took a sizable bite out of the rapidly rising trend of government spending -- indeed that effort exceeds anything I have seen in my Washington experience. But the hard fact is that the achievement of a balanced budget in a reasonably prosperous year -- such as projected for 1984 in the Administration's budget planning -- will require a substantial decline in the ratio of spending to GNP. The spending cuts actually put in place so far would not go nearly far enough to achieve the goal. No doubt, skepticism about the willingness and ability of the nation, and more particularly the Congress, to follow through on spending actions of the magnitude

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required to produce budgetary balance lies behind much of the recent financial market behavior.

In this sophisticated academic setting, I don't want to imply that there is any simple correlation, year by year, between deficits and inflation, or between deficits and interest rates. The significance of a federal deficit in any given year depends upon the general state of the economy and a number of more particular factors, including our potential for saving and competing demands for credit. In a period of high actual or potential saving, falling demand for business and residential investment, and low interest rates, there may be little risk of the sale of securities by the Treasury "crowding out" investment. Temporary losses of revenue as a result of sluggish economic activity need not provoke offsetting action, even though the deficit is affected. But in today's world, where we have repeatedly seen competing demands for credit clashing in the market, and with a chronically low pattern of savings in the United States, it is critically important that we do move toward restoring balance and a surplus in the budget as the economy grows. Our deficit is not simply cyclical but structural. And so long as the structural deficit is so large, we make the goal of sustainable low interest rates and growth in the private economy much more difficult.

Let me give you a few numbers to illustrate my point. In the fiscal year just ended, the economy generated about $185 billion of net savings (that is, gross savings minus the amount necessary to maintain the present capital stock). Of this available savings, the Federal Government preempted aroung $80

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billion to finance the budget deficit and off-budget activities. Consequently, only a little more than half of our savings was available for adding to plant and equipment, to inventories, and to our stock of housing.

The point is often made that, in relation to our GNP, our federal budget deficits are relatively small by international standards. For instance, Germany and Japan, to take two examples, have been able to finance comparable or even substantially larger, central-government deficits -- relative to the size of their economies -- without the same pressure on financial markets. What is usually overlooked is the other side of the equation -- they also save much more -- and it is the relation between the two that counts. In the 1975-79 period, net savings in the United States averaged around 5 percent of our gross domestic product. The saving rate in Germany in that period was close to 12 percent, while the Japanese rate reached 19 percent. They could finance large deficits and a lot of investment, too. We can't.

In the abstraction of economic textbooks -- at least some of them -- a reduction in monetary growth will itself cure inflation in time, and little more need be said on the subject. The more eclectic texts will go on to say the process will be assisted, and strains on financial markets reduced, with appropriate coordination of fiscal and monetary policies. But the analysis should not stop there.

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Monetary policy -- or financial policy generally -- has the effect of imposing a kind of rough ceiling on the dollar volume of transactions that can be financed -- reflected in the nominal GNP. The direct effect on prices is limited; although strong financial pressure can induce price cutting for inventory liquidation, those effects are likely to be temporary. Over time the division of nominal income into inflation and real growth depends largely on the way individuals and businesses approach the problem of setting wages and prices. If the momentum of large cost and wage increases is maintained, then higher prices will eat up much or all of the available dollars and little or no room will be left for real growth. This may seem an abstraction, but it can be translated quite readily into losses in profits, jobs and real income.

I have alluded several times to the signs of progress on the inflation front; for example, the rate of increase in consumer prices slowed from around 12 percent in 1979 and 1980 to 9-1/2 percent over the first eight months of this year. But I do not delude myself about our progress. Much of the relief this year is due to factors that we cannot count on to recur -- stable or falling energy prices, good weather for growing corn and wheat, the immediate pressures of "tight money" and high interest rates on commodity and house prices, and the sharp rise in the foreign exchange value of the dollar.

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Relatively little improvement has been evident in some underlying cost trends that reflect a combination of wages and productivity, and some governmental policies continue to have the effect of ratcheting up costs.

The stubbornness of our inflation in large part reflects the adaptation of our economic and social institutions to persistently rising prices. The process is embedded in a whole pattern of economic, social, and political behavior that tends to sustain -- and intensify -- its own momentum. We see the process at work in contracts that extend over a period of time: in the pattern of three-year wage bargaining, building in past or anticipated rates of inflation into future costs; in attempts to protect one's own purchasing power by indexing, usually to a consumer price index that is itself distorted, even when the growth in productivity and output canot support higher real incomes; in demands for inflation "premiums" in financial markets and interest rates.. We see the same process at work, more informally, when we buy houses for "investment" as well as shelter or consumer satisfaction; when we anticipate, in our pricing, that others will be raising their prices; when we are more preoccupied with how to make capital gains than how to produce.

Sooner or later, starving an economy for money will change that behavior. But the question is -- at what unnecessary cost and strain? Or, to put the point more positively, the more quickly we adapt our behavior to the reality of financial restraint, the more rapid the return to price stability <u>and</u> growth.

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The most critical area -- inevitably, because it accounts for some two-thirds of all costs -- is the trend of wages and salaries. The evidence today is mixed. We can find signs of restraint in some areas, particularly in the important manufacturing sector. But we see other areas where a kind of "business as usual" attitude prevails, continuing to build past inflation trends into future contracts.

1982 will be a crucial period in turning the inflationary trend firmly downward. Unlike this year, it is a major wage bargaining year for pattern-setting industries, beginning with refinery workers and truckers in the winter and spring and running through the auto industry in the autumn. That bargaining is, of course, immediately important for future growth, profitability, and jobs in key industries -- steel, autos, electrical and tire manufacturers, and others. But those highly visible negotiations -- and the signals they send -- will be important far beyond the industries immediately affected. What is at stake is how quickly, and how convincingly, we can look toward a sustained unravelling of the inflationary process, consistent with vigorous growth. Paradoxical as it may sound, pricing and wage restraint can only enhance the prospects for sustained economic growth, and for increases in real wages and real profits for the economy as a whole.

We cannot achieve that result by fiat or by rhetoric. What we can do is remove impediments placed by government itself on competitive forces in the marketplace, and we can certainly avoid new restraints on competition, from at home or abroad.

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We are entitled to point out that restraint in private behavior should "pay off" in more production and more jobs--that, conversely, rapid increases in costs and prices pose greater risks to jobs and profits.

But all of that will sound hollow unless we in the Federal Reserve, and the government generally, do our job. We need to maintain the financial discipline--and particularly restraint on the creation of money and credit--essential to turn back inflation and restore price stability. And we need to maintain that course, convincingly, not just for a few months but for the long pull ahead.

I recognize the exceptional strains on financial markets and on some parts of the economy that discipline has seemed to imply. As I have emphasized, we can help enormously in dealing with those strains by speeding the return to budgetary balance. And, as we see more progress against inflation, and as behavior and expectations reflect that progress, then we will have the base for much lower interest rates--and for keeping them low.

What we must not do is retreat from a course well-started. Too often, that has been the record of the past. And failing to "see it through" has produced the problems -- and pain -- of today.

It is that simple lesson of experience that must be our guide today, and in the months and years ahead. I can only be encouraged by the fact that, that lesson is now so widely understood. And, I believe, you can count on the Federal Reserve to do its part.

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