For release of delivery
8:00 P.M. CDT (9:00 P.M. EDT)
May 19, 1982

REMARKS OF

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BEFORE THE

ECONOMIC CLUB OF CHICAGO

CHICAGO, ILLINOIS

MAY 19, 1982

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I am delighted to be here tonight with the Economic Club of Chicago. But I also realize no Chicago audience needs to be reminded we are in a period of high unemployment and recession. It is a serious recession, made all the more difficult by the fact that in this area of the country, and more generally, our economy has not been performing up to expectations for a long time. Some would say it's gotten worse the more the economic doctors have tried to help and, of course, we would really like a marvelous painless cure.

I can't resist telling you the comment of a good friend of mine who fairly recently had a quadruple bypass heart operation. He said he thought it must be like going through the experience of curing inflation. His operation, he said, was a miserable experience, worse than he anticipated. But once the recovery began, he realized it was more than worth it.

Well, in a sense, our economic patient is still on the operating table. It has been a difficult process, because we have been suffering from the effects of an accumulation of some economic and financial problems that have been developing for a very long time. Those trends were ultimately unsustainable and they have had to be turned around.

We let our productivity growth erode during the past decade and more, so that by the end of the 1970's we were getting no productivity growth at all. But, of course, at the same time we wanted to see our incomes keep ahead of inflation, even if we weren't achieving the productivity improvement that in the end is the only source of growth of real income. And as costs rose faster than prices, profit margins declined. After a while, we came to take inflation for granted -- probably for the first time in American history. We can see more clearly now that many businesses and individuals overborrowed, tempted in part

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by the easy assumption that you could repay credit in cheaper dollars if you waited long enough. And, as society saw less point in financial assets as a way to hold savings, we were surprised and disconcerted that interest rates tended to rise. The whole thing, I think, left us ill-prepared to cope with the energy crisis and other economic shocks that came from outside.

The one thread, in my mind, that underlay all those trends and all those attitudes was inflation. We used to think in the immediate postwar period that a little inflation might be a good thing. It produced pleasant little surprises along the way -- more often than not profits turned out to be higher than anticipated; we could all feel a little richer when we saw the price of our house go up, particularly if we didn't have to buy a new one; we could see that our business mistakes could be covered by price increases and all of that was particularly nice when interest rates lagged way behind the inflation rate. Economists have a fancy name for all that -- when you tend to expect stable prices, and act on that assumption, even though you see inflation -- they call that suffering from money illusion.

What's different, it seems to me, about our current experience with respect to inflation is that it's lasted so long and it's been so high that people began to expect it. We've had inflations before in this country, particularly in war time -- a period in the Civil War when prices went up pretty fast, during and after World War I and during and after World War II -- but none of those periods lasted very long, and I think most people legitimately assumed that we'd return to a kind of norm of price stability after a while. I suspect that was the thought when inflation began climbing after the mid-1970's during the Vietnam war period. But what's unique about this inflation is that

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it didn't last for two or three or four years but it went on for 15 years, and -- with some ups and downs in rate of speed -- it went on at a rising trend.

It's a characteristic of the human animal that after a while he learns from experience. And as soon as people began to expect inflation -- and even exaggerate it in their thinking and in their behavior -- money illusion, in the technical jargon, was gone. That happened some time in the second half of the 1970's. At that point, inflation could no longer be considered fun, and the higher level of interest rates that lenders began demanding to make up for their own inflationary anticipations was one symptom of that.

Now I think, for the first time in the memory of many people, we have a fair prospect of changing that trend and that kind of thinking. In a sense the recession is complicated by all the signs of withdrawal symptoms in this disease of inflation. But I also believe we can make this a period of transition to a much brighter future. That of course has to be the aim of monetary policy, and public policy generally.

Certainly inflation is down and quite plainly so. I know there's still a lot of uncertainty about whether the improvement will last -- it's natural at this stage to be reluctant to accept the evidence that the inflation rate is coming down and to change behavior in the conviction the improvement will last. Lenders have wanted to stay liquid. Longer-term bonds have offered an extra-ordinarily high level of yield, but they have too often tended to go begging in the market place. The home buyer and the businessman haven't been able to raise much long-term money at rates that look reasonable. The market place seems to feel that 15 years of inflation and false starts in anti-inflation policy justify a skepticism about whether we really are going to

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persist in restoring price stability. And, despite visible progress across a broad front, in many areas a momentum of cost and price and wage increases still remains very strong.

As a result, profits are squeezed. The combination of high interest rates and low profits creates a poor investment climate at the moment, despite the tax and other encouragements that have been adopted. All of this is reflected in some acute problems -- high unemployment, weak business, severe financial strains -- all doubly evident in areas of heavy industry. It's very easy to understand the sense of uncertainty and concern that so many people feel in this situation. But I do think there is a much more promising side to the present developments. In a number of industries -- particularly where cost and wages have clearly been out of line -- there seems to be greater recognition of competitive threats and new cooperation between labor and management, reflected in changes in the wage trend and renewed emphasis on productivity. We have changed the fiscal structure in constructive directions to help savings and to help investment and to provide greater incentives, all that will take time to be effective, but the framework is in place. We have the clear possibility of a more stable energy picture after the turbulence of the last decade. We've at least begun to deal with the excessive regulatory burden. And inflationary assumptions, at the very least, have been challenged and questioned and seem to be in the process of change.

It is this process that provides an opportunity -- the best opportunity in years -- to reverse the pattern of the 1970's, to look forward to a sustained period of rising productivity and growth, of higher real income for the average worker -- something we haven't seen for five years or so -- and see that in the context of a return to price stability.

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Now if that sounds like pie in the sky, I can understand the skepticism. But I don't think it is just a dream. After all, this is the way the economy is supposed to operate. It's the way it worked, for instance, in the early 1960's. I thought for a while, coming out of the 1975 recession, when we had a period of a couple of years of good growth combined with declining inflation and declining interest rates, that we were getting back on track. Then we got off again. I won't argue it's going to be easy this time -- it hasn't been -- or that it's going to come about automatically. But I think that prospect does sit out there if we take advantage of the opportunities that exist.

Of course, it is one thing talking vaguely about the more distant future, and another thing to see a recovery actually start. I would emphasize three elements in terms of policy approaches that seem to me to be critical at the moment -- both in encouraging early recovery and in sustaining it. They all have a bearing on conditions in financial markets, and it's conditions in financial markets that are a key to recovery, and keeping it going over time.

It's not going to surprise you at all if I say one of those factors is the federal budget. You may be tired of hearing about it. But I'll ask you to be patient for a couple of minutes because I'm not sure the magnitude of the problem is still fully understood -- the figures are so big and threaten to be so big they kind of numb the mind. And I would even say, in that context, that the current fiscal 1982 deficit -- a number in the general magnitude of $100 billion -- in and of itself is not indicative of a major structural problem. Relative to the size of the economy today, that kind of a deficit in a recession period is not unprecedented. But what is new, what is really unique in our fiscal history so far as I know it, is the outlook over coming

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fiscal years.

If we make some simple assumptions, including the assumption that business will get better year after year -- that the recession will end right away and we will have steady growth of four to five percent or even a little more -- and if we assume all government programs in place as they are now, with all the automatic increases that result in spending over the years ahead, the deficit will rise -- not fall -- as we come out of the recession. It will rise by a very substantial amount. Careful analysts agree that it would be around $200 billion or more by fiscal 1984 -- not very far away. It would rise well above $200 billion in the fiscal years beyond that.

You're talking about amounts equal to as much as five percent or more of the gross national product in periods of business prosperity. That would be a large fraction of what our net savings potential has been in the economy. Of course, we'd like to see the savings rate increase, and I think it will. But the implication is that, if the deficits are that big, there isn't going to be very much in the way of savings to go around for the private sectors of the economy -- for homebuyers, and farmers and industries that so desperately need credit to support their own growth. Left unresolved, deficits of that magnitude mean pressure on the financial markets in the future, pressure that would be reflected in relatively high real interest rates. And as the markets look at that prospect, they are more cautious about lending money today.

Now the encouraging thing about that budgetary outlook is, in a sense, an outgrowth of its very magnitude. I think the nature of the problem is very well understood in Washington today, on both sides of the aisle in the Congress, in the Administration, and elsewhere. Once one understands the size and

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magnitude of the problem there is a kind of compelling need to deal with it. A rather dramatic effort to deal with the budget was made recently by the President and the Congressional leadership. That particular effort failed and that was disappointing. But there is an effort that is continuing -- and certainly the problem remains. Men of good will are attacking that problem, and I remain hopeful -- more than hopeful, expectant -- that that trend will be changed by actions in the present Congress.

The second policy element that I would emphasize revolves more directly around monetary policy. You know there is a tendency to equate monetary policy with interest rates. I often hear the comment -- perhaps not entirely in jest -- that interest rates will go up and down today depending upon which side of the bed I or my colleagues get up in the morning. If we actually had that kind of control, I can tell you you would have different interest rate relationships in the market today because none of us are happy with current levels. But we don't have that kind of control.

Monetary policy is, of course, one factor, an important factor, that can and does influence interest rates over time. But the process by which interest rates are determined is a lot more complicated than simply pulling a single monetary lever -- monetary policy, however important, is still only one of many influences. Moreover, the immediate impact of our actions doesn't tell the whole story -- more important, over time, is the climate of expectations about the economy and inflation, and the balance of savings and investment.

The financial markets are huge. It's not just opinion on Wall Street that counts -- interest rates are influenced by the hopes and fears of all of

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us, as we decide what to do with our money. So far the hard fact is that, when it comes to making commitments for buying bonds, the fears have balanced the hopes. This fear has grown out of the experience of the past decades -- a problem of rising deficits, of inflation, and of failure of purchases of fixed-interest securities to provide much of a return on the investment -- or any return at all -- after allowing for the effects of inflation. It's that kind of perspective that we need to change if we expect interest rates to go down and -- more important than going down for a few weeks or months -- to stay down.

The point has been made again and again that today's interest rates are extraordinarily high relative to current inflation. That is a statistical fact. The question is when will those with money be prepared to act forcefully on the conviction that the inflationary trend will remain subdued -- that the yields available in the market today will in fact prove highly attractive over time. There are a number of signs that attitudes are beginning to change in that respect. I wish I had a magic wand to speed the result, but I don't.

What we do have is some degree of control over the money supply, and, therefore, over the prospects for a return to price stability. Theory and experience both tell us that restraint on money and credit growth is an essential part of bringing down inflation and keeping it down. And if we are to get interest rates down -- and do it in a way that they will _stay_ down -- we have to be concerned about excessive growth of money. That approach, in general terms, it seems to me, is pretty well understood. But, it can be terribly confusing, and even disconcerting, in this age of instant communication, when an overwhelming number of poorly digested statistics are thrown at us practically every day, in trying to follow the trend of money and credit

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growth from week to week or month to month when the numbers bounce around so much. And, even in judging numbers over a period of months or years, we have to be alert to the impact of financial innovation on the numbers or changing behavior patterns.

In setting particular targets for growth of the various monetary and credit aggregates, in reviewing them periodically, and in conducting our actual operations in the general framework of those objectives, we need to take account of the general economic environment -- including conditions in the money, capital and foreign exchange markets, the federal budgetary posture, and other factors.

On the basis of a thorough analysis, the Federal Open Market Committee last February adopted targets for 1982 that we felt, on the basis of experience, should provide enough money to support economic recovery, consistent with continued progress against inflation. That judgment, I believe, was shared by most observers. It is, of course, a judgment that should be, and is, reviewed from time to time.

In making our judgment at the beginning of this year, we did not, and do not now, put exclusive weight -- or anything like it -- on one measure of the money supply. M1 gets a lot of attention in the market, partly because it is the only aggregate published weekly. But I would emphasize it's not the only measure we watch. It may not always be the most important, particularly when it is sensitive to institutional change.

For instance, NOW accounts are still relatively new, but are now a significant share of M1. While M1 is defined only to include transactions balances, we know NOW accounts also have some characteristics of a savings account. If there is a tendency, at the margin, for individuals to hold more

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of their savings in that highly liquid form, induced in part by recession uncertainties, the M1 totals will be affected. At the time we set our targets, we had some evidence -- and we don't yet have the full story -- of a noticeable temporary change in the public's desire to hold part of their financial assets in NOW accounts. At this point, nearly all the expansion in M1 this year has taken the form of NOW accounts, and that increase, we believe, reflects partly a savings or precautionary motive, in addition to the ordinary transactions motivation. As a result, M1 so far this year has grown slightly faster than our target range may seem to imply. But to the extent this reflects a savings or precautionary motive rather than a transactions demand for money, we do not find this terribly troubling. That judgment is strengthened against the background of other measures of money, liquidity, or credit expansion, reflected in our other target ranges. Taken together, the current results seem to me reasonably on track with respect to our policy intentions.

You may recall that last year M1 grew relatively slowly, while M2 expanded around the upper end of our target range. We believe that this was a reflection of financial innovations, including prominently the rapid growth of money market funds, which to some limited extent serve the function of transactions balances. Taking all this into account, we didn't find the pattern of slow growth of M1 so disagreeable as to take vigorous action against it so long as M2 and other measures were growing relatively rapidly. Similarly, at the moment we don't find the pattern of growth in M1 so far this year-- combined with behavior of the other aggregates consistent with intentions, and given the evidence of some shift in public savings patterns -- to be out of line with our purposes.

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I realize that's technical stuff. Obviously, we want to have enough financial growth to support recovery. We also must make sure that monetary policy remains concerned with, and directed toward, restoring price stability, and we don't believe that's an objective that we can turn on and off like a faucet -- not if we want the effort to be successful. To attempt to push interest rates down by excessive money creation at the expense of inflationary fears would, it seems to me, be shortsighted. In a practical sense, it wouldn't work for very long in the current environment, when the sensitivity to inflation remains so strong.

Let me emphasize, in that connection, that a strong budget program could only work in the direction of lower interest rates, within the context of any given monetary growth. It would do so by helping to reduce future credit demands reinforcing emerging expectations of less inflation. It would make our job in the Federal Reserve easier -- more important, it would make the lot of other borrowers in the market much easier. In that sense it would be an important support to getting the recovery started and sustaining it.

The third area I would touch upon is to point out the inflationary process is nurtured by a state of mind; once started it tends to maintain its own momentum in interest rates, in wage bargaining, in pricing policies, and all the rest. You know, if you're under the age of 35 and you've been working since you graduated from college or high school, you've never known anything but higher prices in your whole working career. Along the way you got used to annual increases in salaries and wages year after year that partly reflected inflation. You got used to accumulating financial resources by capital gains in your house. You thought price stability would be nice when you went to the store, but on the other side of the coin, there's a natural reluctance to

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give up the increases in income that went along with the inflationary process -- or to lend your money on terms that used to be considered reasonable.

Today, the price trend has changed. But, as the momentum of cost increases moves down less rapidly, there is a squeeze on profits. There is not enough money to finance real investment and inflation at the earlier rate of speed. In time, that process will make inflation subside -- we see it happening now -- but in the meantime, business activity can be affected as well. You can try to solve that dilemma by sharply accelerating growth in the money supply -- by a willingness to finance inflation. But in my judgment, that will not prove to be a solution at all, because it will only perpetuate the process. The dilemma ultimately has to be solved from the other direction, by reducing costs, restraining nominal wages and salaries, and by increasing productivity. The problem is most clearly and directly apparent in those areas of the economy where strong competition from at home and abroad highlights relatively high costs and prices, but the lesson is more general.

It's very easy to understand the reluctance of many to accept as a premise of their own behavior that inflation is coming down, because they've seen the opposite experience for so long. But I also have to say that those who plan on inflation in their management and labor practices -- those who in effect bet against the nation's success in restoring price stability -- should think about the consequences of their actions when those expectations turn out to be unwarranted.

The fact is restraint on all sides will pay enormous dividends. For too long, the average worker had practically no growth in real income. With rising productivity as recovery gets underway, the average worker and family can expect higher real incomes, even as nominal wage and salary growth

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slows down. The process of disinflation will, I believe, attain a kind of momentum of its own -- success can breed confidence and further progress. In that context, interest rates at today's levels would appear ridiculously high -- a kind of historic aberration -- and over time they would have no place to go but down. More favorable financial market conditions will, in turn, help keep the economy growing, and provide the support for investment to encourage further productivity.

I know we're not over the hump to that happier world, despite the visible progress we can see on inflation. But I do think we can begin to sense the necessary change in attitudes. And I do think we have the best chance in memory of reversing the adverse trends of these past years -- of making this recession not another wasted, painful episode, but a transition to something better.

We still have a lot to do. To fail to carry through now on the budget, on disciplined monetary policy, on bringing down costs and improving productivity would only leave us with still more difficult dilemmas and problems for the future.

I don't pretend any expertise in political analysis or social behavior. But the pain of the unemployed is obvious -- nowhere more so than in the industrial heartland where so much of the pressure has been concentrated so long. Carl Sandburg's description of Chicago as a "city of the big shoulders" has a new meaning.

I also know something of the strains in financial markets and the uncertainties and concerns of so many of our citizens.

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But I also sense there's a kind of common sense in America that realizes that strong action has been necessary to put the economy right. And I also sense the tide is turning, that we can look forward in fact to much greater price stability, that recovery can soon begin, and more important -- with the right policies -- that recovery can be sustained. So this basically seems to me a time for optimism and hope, a time when, a year or two from now, we're going to be able to look back and say all that pain and effort and uncertainty was not in vain.

Thank you very much.

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