For release on delivery
8:00 PM, EDT
May 25, 1982

Remarks of

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Chairman, Board of Governors of the Federal Reserve System

before the

Money Marketeers of New York University

New York City

May 25, 1982

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I am pleased to be in New York tonight with the Money Marketeers, even though it's problematical whether it helps the digestive process to have dinner with people who are trying to outguess what the Fed is doing from minute to minute and hour to hour. I have had some concern that whether I ate rapidly or slowly, or with the right hand or left, might be presumed to have some occult market significance. At any rate, no matter how long or attentively you listen, you are still going to have to make up your own minds about how the market will open tomorrow, or next month, or next year.

Instead of looking at the nitty gritty of the financial markets tonight, I'd like to step back a few paces and suggest some perspective about what we are trying to do as a framework for evaluating the market. I need not tell this group that we are in a serious recession in this country today, made all the more difficult by the fact that our economy has not been performing up to expectations for a very long time. We'd like to have some marvelous painless cure for our troubles but that,unfortunately, is not the case.

We have been going through 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. At the same time we wanted to see

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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. We can see more clearly now that many businesses and individuals overborrowed, tempted in part 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.

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

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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-1960's during the Vietnam war period. But what's unique about inflation is that 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 soon people began to expect inflation -- and even exaggerate it in their thinking and in their behavior. 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. I 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

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the evidence that the inflation rate is coming down and to change behavior in the conviction the improvement will last.

There is certainly reason to believe that the relatively good performance of both the producer and consumer price indexes in recent months reflect some temporary or non-recurring factors. The momentum of cost and price and wage increases remains strong in a number of sectors. Much of the gain in price performance has been achieved in the midst of recession. And 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 persist in restoring price stability. Consequently, many lenders have wanted to stay liquid. Longer-term bonds have continued to offer an extraordinarily high level of yield historically, and the home buyer and the businessman haven't been able to raise much long-term money at rates that look reasonable.

At the same time, there is no denying signs of progress -- potentially lasting progress -- in restraining costs and setting the stage for productivity improvement. That is particularly evident in sectors of the economy where costs and wages have been more clearly out of line with domestic and international competitive realities. If the speed of our progress is exaggerated in some price statistics, I would also note that the reduction in the consumer price index can also feed back into the wage setting process. In this setting, it would be hard to deny a change in the basic inflationary trend is, at the very least, within our grasp.

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The other side of the story is that with cost containment, perhaps inevitably, lagging behind the declining inflation rate, and with volume sluggish, 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, and severe financial strains. It's very easy to understand the sense of uncertainty and concern that so many people feel in this situation. The challenge for policy -- the challenge for all of us -- is to resolve those uncertainties in a constructive direction, building on what has been achieved.

In that connection, a number of important steps have already been taken.

- oo The fiscal structure is moving 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.
- oo There is a clear possibility of a more stable energy picture, after the turbulence of the last decade, even though the recent weakness in prices has, for the time being, seemed to have come to an end.
- oo The excessive regulatory burden is being attacked.

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oo 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 in the context of a return to price stability. In that context, the average worker should be able to see his real income increase, something that hasn't happened for five years or so.

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. But, of course, it is one thing talking vaguely about the more distant future, and another thing to see a recovery actually start, and to see it sustained.

I would emphasize three elements in terms of policy approaches that seem to me to be critical to help make the objective a reality. They all have a bearing on conditions in financial markets, and it's conditions in financial markets that are one key to recovery, and keep it going over time.

It's not going to surprise you at all if I say one of those factors is the federal budget. I am among experts, and won't belabor the point. You know the potential deficit figures are so big they kind of numb the mind. The problem is not so much the current fiscal 1982 deficit -- a number in the general magnitude of $100 billion. Relative to the size of the

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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 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 would rise -- not fall -- as we come out of the recession. It would rise by a very substantial amount. Your projections may differ by tens of billions as the time horizon lengthens, but the point is the estimates center around $200 billion or more by fiscal 1984 -- not very far away. They rise well above $200 billion in the fiscal years beyond that.

To put that in perspective, with "no action" we would be facing deficits equal to as much as five percent or more of the gross national product in periods of business prosperity, not so much less than the rate of net savings in recent years. We would like to see the savings rate increase, and tax and financial market changes, I believe, point in that direction. But the clear implication of the budgetary picture is that, if the potential deficits are not sharply cut, those deficits would absorb an historically large fraction of any realistic projection of our

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savings potential for a period of growth and prosperity. There wouldn't be very much in the way of savings to go around for the private sectors of the economy -- for home-buyers, and farmers and industries that so desperately need credit to support their own growth. Left unresolved, the deficits could only mean pressure on the financial markets, pressure that would be reflected in relatively high real interest rates. As the markets look at the prospect, they are more cautious about lending money today. And, the analysis calls into question the prospects for sustained expansion -- certainly an investment-led, productivity-inducing expansion.

Now the encouraging thing about that budgetary situation is, in a sense, the flip-side of its magnitude. The threat is so evident, the need for drastic surgery is much better understood in Washington today, on both sides of the aisle in the Congress, in the Administration, and elsewhere. Once one understands the size 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 the effort is continuing -- through the more usual budgetary processes. By its nature, those processes may not offer the same dramatic or catalyzing potential. A budget resolution leaves open questions about how the targeted savings will, in fact, be implemented. But a resolution, combined with reconciliation procedures, would be a forward step, and the will of the Congress

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to implement the program in actual spending and revenue increases will soon be tested. The manner in which that test is passed will be crucial, but there seems to me some grounds for encouragement.

The second policy element that I would emphasize revolves more directly around monetary policy. Even with a highly sophisticated audience, discussion of monetary policy can be confused by semantic difficulties -- what we mean by "tight" or "easy" money -- as well as by differing substantive interpretation of the data.

In any event, I need not, before you, linger over the point that the process by which interest rates are determined is a lot more complicated than simply pulling a single monetary lever. Monetary policy is important, but it is still only one of many influences, and 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 point has been made again and again that today's interest rates are extraordinarily high relative to <u>current</u> inflation. That is a statistical fact. But the relevant question, in assessing real interest rates, is what people expect, and when those with money will be prepared to act forcefully on the conviction that the inflationary trend will remain subdued.

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There are a number of signs that attitudes may be 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 both the actual prospects for a return to price stability and expectations of that prospect. 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, in this age of instant communication, when an overwhelming number of poorly digested statistics are thrown at us practically every day, it can be a confusing and difficult process to try to follow the trend of money and credit growth from week to week or month to month when the numbers bounce around so much. And, apart from the sheer statistical noise, we have to be alert to the impact of financial innovation on the numbers and to changing behavior patterns in evaluating movements over a period of months or years.

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 assess those factors affecting monetary aggregates against the background of conditions in the money, capital and foreign exchange markets, the federal budgetary posture, and other factors.

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On the basis of its 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 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,

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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. I would note that, at the same time, the sharp decline in savings accounts -- for precautionary purposes, a closely comparable asset -- was reversed.

Reflecting the surge in NOW accounts, M1 so far this year has grown slightly faster than our target range may seem to imply. 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 divergence 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 reasonably

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consistent with intentions, and given the evidence of some shift in public savings patterns -- to be out of line with our purposes. I would also note that, with economic recovery, the "precautionary" element in M1 or other aggregates could subside.

Looking through these technicalities, the basic problem -- and objective -- remains. We want to have enough financial growth to support recovery. But 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.

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. Price stability

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always seems nice when you are on the "buy" side of the market, but as sellers there is a strong inclination to try to keep the process going.

Today there is not enough money to finance real investment and inflation at the earlier rate of speed. That process is making inflation subside, but in a transition period 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.

It's 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.

In time, the process of disinflation can, I believe, attain a kind of momentum of its own -- success can breed confidence and further progress. In that context, I think we would agree, interest rates at today's levels would appear absurdly high -- a kind of historic aberration.

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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.

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