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Sustainable Recovery: Setting the Stage

Remarks by

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I am delighted to be with you tonight for several reasons.

First, I can take special pleasure in joining you to honor Dick Hill. For many years, he has stood in the first rank of bankers, not just in Boston and New England, but in the nation and the world. But with Dick, banking responsibilities have been combined with a clear sense of the public interest. It is that quality that over many years has brought Dick into close contact -- as Director of the Boston Fed, as a member and President of our Federal Advisory Council, and in less formal contacts -- with me and my colleagues and predecessors in the Federal Reserve. He has been as unstinting in his wise counsel to us as I know he has to many of you.

Second, I welcome the chance to share thoughts about our economic problems with members and friends of the New England Council. Your organization has had a mission -- to analyze dispassionately the problems of a once relatively depressed region, to propose constructive approaches and develop a needed consensus for action, and to "stick with it" year in and year out. The relative strength and progress of the New England economy in recent years stands in part as a tribute to your faith and efforts.

Of course, New England, like every other region of the country, has not been exempt from the effects of national problems. I need not linger over the human and statistical evidence of economic trouble -- the postwar record unemployment rate, the unutilized industrial capacity, the signs of stress in financial markets, and the rest. You know all that, and we also know the sense of uncertainty and even frustration that these developments breed.

But this period can also be one of great opportunity -- an opportunity, with reasonable good sense and good management, to set the economy on a course of sustainable growth for many years ahead. Indeed, I believe substantial progress has been made in laying the foundation for that growth. Of course, there are some big potential stumbling blocks ahead -- and I will be touching on them tonight. But, first, let's summarize where we are.

For long months we have, quite obviously, been in recession. Our situation has many of the characteristics of earlier, recurrent postwar recessions. But to consider recent developments as "just another recession" would, to me, miss the essential point.

For more than a decade, roughly encompassing the 1970's, our economic performance had been deteriorating in fundamental ways. We had come earlier to take growth of 4 percent or more a year for granted. But the rise in productivity necessary to support that kind of growth simply dwindled away; by the end of the 1970's it had practically disappeared. At the same time. inflation got out of hand. We found ourselves with the most persistent and largest increase in price level since the Continental dollar; after a while, we had come to expect it -- to anticipate it in our business decisions, in our financial planning, and in our shopping. As we did so, we tended to leverage our capital, to reduce our liquidity, to divert our energies into more speculative and unproductive activities -- to take risks in ways that could not be sustained. And in the end, the growth we took for granted was undermined.

By the late 1970's, the country began responding -- responding most particularly by attaching high priority to the effort to deal with inflation. The Federal Reserve, by necessity, has been at the leading edge of that effort, recognizing no inflation can be stopped without appropriate restraint on the growth of money and credit. And that effort was made more difficult because complementary approaches were weak or lacking.

We should never have anticipated that dealing with a deeply entrenched inflation would be fast and easy; it has not been. Strong pressures on credit markets, with interest rates affected by continuing inflationary expectations, have burdened capital intensive industries in general, and housing in particular. Plans undertaken and financed in the expectation of rapidly rising prices have had disappointing results, in some cases leading to unanticipated financial strains and even bankruptcy. Profits have been hard hit as prices have stabilized faster than costs and volume has declined.

We are still some distance from price stability. But I do believe we can now fairly claim the insidious upward momentum of inflation has been broken. I judge that not simply by the fact that the common indices of inflation this year have been running at a third to a half of their earlier peak levels. I believe we also see signs that the hardened skepticism of financial markets and the public at large about our ability to deal with inflation -- a skepticism bred over years of disappointment and false starts -- is beginning to yield. One reflection is the rapid decline in long-term interest rates in recent months -- although they are still very high historically. And there are hard analytic reasons to believe that progress toward stability can be maintained during a period of business recovery.

Part of my optimism in that respect is rooted in a sense that the stage is being set for restoration of productivity growth. Typically, productivity does poorly in a recession; it's hard to increase output per worker when total output is falling, as it has been. But business after business reports more intense efforts to boost efficiency, and in many instances there are signs of a new sense of cooperation between management and labor. Recent data suggest some tentative signs of more favorable results. But the real payoff should come in a period of expansion.

At the same time, the upward trend of wage and salary costs has slowed. The pattern is uneven among industries and companies, partly because of contracts extending over several years. But it is unmistakable.

With inflation slowing, that restraint on nominal income has been fully consistent with higher real income for those working. The demonstrated progress against inflation -- combined of course with the currently excessive levels of unemployment -- should be reflected in further restraint on the growth of nominal wages. Together with rising productivity, the result should be slower growth in unit wage costs, paving the way for further progress toward price stability and the higher real incomes we want as the economy expands. To be sure, movements in food, energy, and commodity prices may not be so favorable to the consumer -- they have all been affected by the recession. But neither is it likely we will face the kind of agricultural or energy price shocks we had in the 1970's.

I do not equate that progress against inflation with victory -- far from it. Concern about inflation is not something we can afford to turn on or off -- not if we want to see that progress continue and price stability restored. That concern will, in turn, require continued vigilance in keeping appropriate restraint on the growth of money and credit -- a matter upon which I will say a few words in a moment.

That restraint, I should emphasize, is not the equivalent of a high interest rate policy -- quite the contrary. Lending for any period of time is in essence an act of faith -- faith, among other things, that interest paid in the years ahead will yield a real return and not lag behind rising prices.

The rapid declines in interest rates over recent months, particularly in the longer-term markets, have, I believe, partly reflected a basic reappraisal of the outlook for inflation. Those declines in turn appear to be contributing to some revival in homebuilding and supporting other sectors of the economy. I am well aware interest rates are still historically high, and that it is not yet clear that a broad-based recovery is underway. Obviously, in the circumstances, further reductions in interest rates would be welcome. But we also want to be sure that lower rates can continue so that the recovery will last. Therein lies the challenge for economic policy -- and for monetary policy specifically: we need to combine recovery with further progress toward stability or we would risk losing both.

As you know, most of the monetary and credit aggregates that the markets watch so closely are running somewhat above the targets we set for ourselves at the start of the year. So far as M1 is concerned, the data have plainly come to be distorted by institutional change -- particularly in October by a flow of funds into checking accounts as a large amount of All-Savers certificates have matured. Prospectively, the introduction of new forms of transaction or quasi-transaction accounts are likely to distort the figures further, although the direction of impact is less evident. In the circumstances, we have had little alternative to attaching much less weight to that aggregate in guiding the provision of reserves until the institutional changes settle down.

More generally, current developments with respect to the growth of money and credit have had to be interpreted in the light of all the evidence we can gather with respect to the economy, price developments, interest rates, and financial pressures. Taken together, the evidence is strong that the desire for liquidity has strengthened appreciably this year, as sometimes happens in periods of exceptional economic uncertainty. The turnover or "velocity" of "M1 money" has, for instance, declined appreciably this year, instead of trending upwards as has been the pattern thoughout the post-war period. M2 velocity -- generally stable in most recent years -- has declined even more sharply.

In all these circumstances, the Federal Open Market Committee has remained willing for a time -- as we indicated at midyear -- to tolerate monetary expansion at a somewhat higher than the targeted annual rate. That approach, in the light of the evidence of exceptionally strong liquidity demands, should in no way be interpreted as lack of continuing concern about inflation -- and happily I do not believe it has been so interpreted by the markets. The fact is that, with velocity patterns obviously shifting at least for a time, rigid pursuit of targets would have had the practical effect of a more restrictive policy than intended when these targets were set out. It is not without relevance, in that connection, to note that growth in bank credit, or private credit generally, has been relatively limited this year, tending to confirm that the greater liquidity provided has not spilled over into inflationary private credit expansion.

What recent developments do emphasize is that, in a time of rapid institutional and economic change, we must be wary of highly simplified rules in the conduct of policy. That is why we have always looked to a variety of monetary and credit "targets," and retained elements of flexibility and judgment in pursuing those targets.

What we do not have the flexibility to do is to abandon broad guidelines for monetary and credit growth as a means of judging policy over a period of time. The danger of creating excess liquidity is not so much immediate, when there is so much surplus capacity and unemployment, but rather when the economy begins to regain forward momentum. That is why we must continuously balance the need to meet liquidity needs today against the risks of building in fresh impetus to inflation tomorrow. And, that is also one reason why the prospective position of the Federal budget remains of so much concern.

In the fiscal year just ended, the Federal deficit was $111 billion, and it could well be 50 percent higher in the current fiscal year. That current deficit, approaching 5 percent of the GNP, overstates the "structural" budgetary problems. High unemployment cuts revenues and increases spending, temporarily enlarging the deficit. Indeed, the current deficit, while hardly welcome in so large a size, does provide support and impetus to the economy at a time of cyclical weakness.

But the hard fact is that, as things now stand, the deficit will remain close to current levels even as the recession passes. Left unattended, the budget situation poses a strong potential for a clash between the need to finance the deficit and the rising financial requirements for housing and for the business investment needed to support lasting growth in productivity. Simply pumping out more money and liquidity, year after year, to meet the needs of the government would risk renewed inflation and drive investors away from the long-term markets once again. The alternative of the government bidding away a limited supply of credit from the homebuyer or businessman is hardly more inviting -- and would also be reflected in high real interest rates. Understandable concern about one or the other of those "scenarios" feeds back into today's markets, tending to keep interest rates higher than they would otherwise be.

There was meaningful progress on this front in the passage of tax and spending legislation last summer; it was particularly encouraging that the Congress and the Administration acted in the face of an election with the economy in recession. Further progress will not come easily. But I am encouraged by the degree of consensus on the need to continue in the direction of fiscal moderation and by the fact that so much of the debate centers on "how" rather than "whether." It is the budgets for 1984 and beyond that seem to me especially critical, for the private economy would then be expanding more rapidly. But we should clearly understand that failure to act with all deliberate speed would, quite simply, be a major block to recovery and its sustainability.

The remaining problem area that I would like to touch upon more fully is international economic and financial conditions. More than ever before in the postwar world, prospects for sustainable expansion are closely tied to what happens abroad. And other countries are, of course, partly dependent on our own policies and approaches.

Not just the United States but the entire industrialized world is in recession. In greater or lesser degree, the economic and financial circumstances of other countries parallel our own -- and for similar reasons. Unemployment is at record levels, prospects for near-term growth today seem limited, and the financial ties that bind us to the developing world have become strained. Should we fail to understand the full extent of these difficulties or respond inappropriately, no country will escape the consequences.

The problems of the rest of the industrialized world and their policy approaches are so similar to ours that I need not linger over the analysis. Suffice it to say that our recovery can assist theirs -- and vice versa -- just as the heartening progress on the inflation front has been speeded by the interactions among us. What is a threat to us all is the evident pressure toward greater protectionism. There are those who in our present situation would draw parallels to the 1930's -- usually with little foundation. One major difference has been that we have not, by and large, yielded to the temptation to retreat behind national barriers to trade, with the inevitable result of cutting off each other's markets, impairing growth in trade, and dulling competitive pressure on prices. But there are too many exceptions to that generality to permit us to rest easy.

Another threat -- essentially without precedent in the postwar world -- is an outgrowth of the financial difficulties of much of the developing world. Those developing countries, for all their problems, have been a growing, dynamic feature of the world economy. Even during the 1970's, in the face of enormously increased energy prices and slower growth in the industrialized world, they maintained strong forward momentum. That growth was marred, however, by increasingly large external payments problems. The current account deficits of all non-OPEC developing countries soared to $75 billion or so after the second oil crisis and continued at that rate into this year.

For a time, those deficits were supported by a vast expansion in international credit. Some of that credit was official -- relatively inexpensive and long-term. But an increasingly large chunk was from commercial banks around the world. According to available data, which may well be incomplete, outstanding bank credit to the non-OPEC developing countries doubled from 1975 to 1978 -- from about $60 billion to about $125 billion -- and then nearly doubled again to about $230 billion by the end of 1981.

The process of rapid debt accumulation could not be sustained indefinitely. The potential problem was brought to a head at this time by a combination of circumstances. Sharply higher interest rates increased debt service requirements rapidly relative to the capacity to service debt. The widespread recession in the industrialized countries and the declining level of real world trade restricted markets for the exports of the developing countries. Declining commodity prices put further pressure on many developing countries still dependent on commodity exports for a large portion of their foreign exchange earnings.

The result is that, in the past year or so, we have seen several important borrowing countries -- first in Eastern Europe and then in Latin America -- reaching the limits of their ability to keep up the servicing of their foreign debt. As these countries experienced strain, the flow of bank credit to some others -- freely available only a few months before -- was curtailed, threatening further problems.

In this situation, the need for closing the gap in external payments -- sometimes at the expense of stopping internal growth for a time -- is unambiguous; when the supply of new credit is reduced, there is simply no alternative. The key question is how orderly this adjustment process will be. The more orderly and effective the adjustment, the more rapidly growth in the developing world can be restored and sustained, the more our own export markets and those of other industrialized countries will expand, and the more promptly any questions about the possible impact on the earnings of international banks can be put to rest. It is precisely for these reasons that there exists the strongest kind of community of interest among borrowers and lenders, among governments and private businesses, and among the developing and industrialized countries, in working together to find effective answers to the evident problems. Each of the parties has a critical role to play -- sometimes together, and sometimes separately. What is especially important is that all these participants achieve a high degree of common understanding, recognizing the potentialities and limitations of each for action. On the basis of that understanding, we can then deal forcefully and effectively with the problems at hand.

In the first instance, the borrowing country itself has the heaviest responsibility, for it must initiate and carry out the needed adjustments in its own economic policies. I do not underestimate the difficulties of such adjustments for relatively poor countries, often with rapidly growing populations and beset by political problems. But we are also fortunate that the principal countries involved have important economic strengths, demonstrated growth potential, and able economic officials who understand the needs and requirements of the situation. Current liquidity problems need not be -- and for the major borrowers they are not -- symptomatic of inherent economic weakness.

Several countries -- important in themselves and important as examples -- have taken the significant step of entering into negotiations with the International Monetary Fund, seeking the kind of international endorsement of strong adjustment programs that IMF imprimatur carries. Just last week, essential agreement on so-called "letters of intent" was reached with Mexico and Argentina, and negotiations are underway or about to begin with other major borrowers.

Agreement with the IMF brings with it the availability of certain amounts of medium-term financing, usually over a three-year period. To assure the adequacy of IMF resources in current and prospective circumstances, the ongoing negotiations to enlarge the funds available to it should, and can, be brought to an early conclusion. Both a sizable increase in basic quotas and a reliable standby borrowing arrangement -- along the general lines proposed by the U.S. Treasury some months ago -- can be readily justified. Agreement on both, now, seems to me doable. And such agreement would convincingly demonstrate the capacity of countries to act together to meet extraordinary needs.

I realize some time will be required to obtain necessary legislative approval in each country involved. But early international agreement will provide the tangible assurance necessary to permit full commitment of presently available funds if needed, and those funds could be temporarily supplemented by IMF borrowing from the market or directly from member countries.

The importance of IMF participation in adjustment programs is not limited to the amount that institution can itself lend. The Fund is in a unique position for evaluating, dispassionately and impartially, the policies of its member countries. Approval of adjustment programs proposed by the member will reinforce the confidence of other lenders, paving the way for needed extensions of official and private credit.

In certain circumstances, national monetary authorities, acting separately or jointly under the auspices of the Bank for International Settlements, have been called upon to provide some short-term "bridging" credit to help maintain continuity of international payments and ease financial shocks. Mexico and Hungary have been cases in point. But cases of that sort can be justified only by a clear threat to the international banking system as a whole; monetary authorities have neither the capacity nor the authority to substitute short-term central bank credit for needed medium or longer-term financing.

To some extent, more conventional means of official financing support, such as official export credit agencies, can play a role. But, in the end, some borrowing countries will find it necessary to arrange some restructuring of their outstanding debts and, for a time, to seek fresh credits from the commercial banks that have been large sources of funds in the past.

I fully realize that the extraordinarily rapid growth in bank lending to some countries in the recent past cannot reasonably continue indefinitely. But it is also an obvious fact that some of the largest borrowers are not in a position to repay debts suddenly, and an orderly adjustment program -- a program fundamentally in the interest of borrower and lender alike -- will frequently require at least transitional financing beyond amounts appropriate to, or feasible for, the IMF and official lenders.

It is equally a fact that, given strong and necessary adjustment programs, borrowing countries will not require bank financing in amounts nearly as large as the sums provided by banks over recent years. Indeed, lending banks, working effectively together to meet a clearly justified transitional need, should be able to provide the necessary margin of finance while reducing ratios of outstanding loans relative to their capital or assets. In a number of instances, outstanding loans need not rise much if at all next year, although negotiations to extend or rollover current maturities may be necessary.

From the standpoint of the banks themselves, such restructuring and the provision of some additional credit, alongside and dependent upon agreed IMF programs, will in some instances be the most effective and prudent means available to enhance the creditworthiness of borrowing countries and thus protect their own interests. In such cases, where new loans facilitate the adjustment process and enable a country to strengthen its economy and service its international debt in an orderly manner, new credits should not be subject to supervisory criticism.

As we look ahead, both private institutions and the relevant authorities and international institutions should develop more effective means of heading off crisis. Some banks have already undertaken promising initiatives to bolster their information sources and lending judgments. The IMF, with resources appropriately enlarged, is likely to have an even larger role to play in maintaining essential discipline. The

World Bank may wish to work more flexibly in coordinating some of its lending with the Fund. Banking supervisors will need to review in the light of experience their own criteria, sources of information, and approaches toward the surveillance of international lending.

But that is for the future. The main requirements for dealing with the present situation are clear enough. The corrective process in some countries is fairly under way. The necessary further actions can be taken in the space of coming weeks and months, so long as we have the wit and the will to do so.

The theme of my remarks tonight can be summarized in a few sentences. We have all come to recognize that lasting prosperity must be built on a sound currency. We cannot deal with our economic problems in isolation from other countries. It's a complicated, difficult world, and the obstacles to progress are not going to yield to one-dimensional approaches.

At the same time, we must not permit any sense of frustration and impatience to blind us to how far we've come in setting the stage for renewed prosperity. We can continue the progress against inflation. We can deal with the budget problem. We can manage the threats to the fabric of the international financial system. We have strong and resilient financial institutions, and an effective apparatus of governmental institutions to contain and diffuse strains.

Those are some of the major reasons that I am convinced we can make the 1980's the reverse of the 1970's -- a decade of renewed stability and progress -- a decade in which the doubts and uncertainties of today will give way to renewed confidence and vigor.

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