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Remarks by

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Chairman, Board of Governors of the Federal Reserve System

at

Dedication Ceremonies

for the

Federal Reserve Bank of San Francisco

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I am delighted that so many leaders and citizens of San Francisco, of California, and of the West have joined those of us in the Federal Reserve for this event today.

A fine new building can represent many things. For our colleagues in the San Francisco Fed, it is a place to work, and much effort has gone into making it efficient, flexible, and pleasant. For San Francisco, we would like to think the new building can become a landmark, helping to anchor and dignify one end of the business and financial district. But a Federal Reserve Bank -- each of the Federal Reserve Banks -- is also part of a larger Federal Reserve System; and a new building symbolizes in a concrete way the roots of that System in the business life of the country we serve.

The Federal Reserve is an instrumentality of the Federal Government -- a creature of Congress, a part of the apparatus of national economic policy making, a guardian of the stability of banking and the payments system, a provider of more mundane but essential financial services. What it is not is "just another Federal agency," with all power and influence flowing from a Washington headquarters. Seventy years ago, when the Federal Reserve Act was passed after years of debate and consideration, there was a more imaginative idea -- a conception that indeed provided for a central supervisory board in Washington, but also included important elements of regional and community participation and counsel in our work.

It was all quite deliberate -- designed in important part to secure a certain independence in judgment, a continuity and professionalism in staff, a close contact with economic developments and opinion throughout a great land, and a degree of insulation from partisan or passing political concerns. Through the decades, the way we have gone about our work, in specific terms, has changed a lot. From time to time, we even need a new building -- among other things, that neo-classic palace down on Sansome Street wasn't really designed for computers, for high speed currency counters, or for a staff of the present size. But what is more remarkable, through the years of economic, technological, and social change, is how stable the basic conception and design of the System as a whole has proved to be.

Today, as in 1914, the twelve regional Federal Reserve Banks and their branches draw on the practical experience, the knowledge, and the advice of more than 250 men and women directors -- industrialists and union officials, bankers and educators, farmers and storekeepers -- all leaders in their own communities. The Banks are staffed with professionals, and they participate through their Presidents in the decisions on monetary policy, as well as carrying the operating load. Advisory councils of bankers, of thrift institutions, and of consumers, enlarge the participation further, and widen our contacts with the public we serve.

All of that is designed to assure that our policies are not conceived in an ivory tower or implemented without a clear sense of the realities of economic and business life. Nor can

monetary policy -- for all its seeming air of mystery and complexity to many -- be sustained without broad understanding and support from the people whose lives, in the end, are so intimately affected. In that sense, we are not, and cannot, be independent of the "body politic" in the broadest meaning of that phrase -- we are, after all, part of "Government."

But Congress, in its wisdom, had another purpose in mind as well -- an independence or insulation, built into the basic structure of the System, from the passions of political life, more narrowly construed. Members of the Board of Governors have long terms, their terms are staggered, and they cannot be removed because of policy differences. Federal Reserve operations are financed from its own resources, and its decision making is not subject to review or audit by the executive. The policy process has elements of decentralization, and the regional banks have an identity of their own. The System reports to, and is accountable, directly to the Congress, which has the constitutional authority over money.

Those decisions were not accidental, nor were they a reflection of a particular period of history. From time to time they have been reviewed and essentially reaffirmed. Indeed, the more important changes in the laws governing the System were in the direction of reaffirming, or reinforcing, the independence from the Executive. In the 1930s, the Secretary of the Treasury and the Comptroller of the Currency were removed as ex officio members of the Board and the term of office of Members of the Board of Governors was increased. In more recent years,

reporting requirements -- to the Congress -- have been made more specific and demanding.

Sometimes the charge is made that the structure of the System is "undemocratic," apparently on grounds that the policy decisions are not made by elected officials. But it is, of course, elected officials who have established and maintained the structure, and who decided to delegate their constitutional power. While the Federal Reserve structure is indeed unique in important respects, the general concept of an "independent" regulatory agency is common in our system of Government, and indeed one of three constitutional arms of Government -- the Supreme Court -- is itself made up of appointed officials.

The issue, it seems to me, is not democracy, but what basic arrangements best suit the needs of the economy, of our Congress, and of our constitutional framework. Congress in creating and monitoring the Federal Reserve System has directed that System toward certain basic goals of public policy -- stability, growth and employment -- goals that are embodied in the Federal Reserve Act, the Employment Act of 1946, and the Humphrey-Hawkins Act of 1978. At the same time, I believe the Congress has consistently recognized that decisions on monetary policy are both technically complex and easily distorted by short-term or partisan considerations.

History is replete with examples of "clipping the coinage" -- or in more modern dress, temptations to create money as a way out of budgetary problems. All too often there are conflicts between short-run concerns and what is

necessary to encourage economic health over time. A central bank under the direction or influence of the Executive may find it difficult or impossible to be a consistent, strong voice for stability when the pressures of the day are in another direction. And the Congress itself would find it organizationally and politically difficult to direct and supervise monetary policy directly, with potentially controversial matters requiring continuing consideration and decision.

All these considerations seem to me to remain valid -- pointing to the need for a central bank that can maintain an independence of judgment, combined with internal checks and balances to assure that policy is broadly conceived, thoroughly challenged and tested, and carried out in a nonpartisan manner. In our society, continuous and open discussion and dialogue with the Congress and the Administration are essential parts of that process. That can be achieved in a variety of ways. So far as the Congress is concerned, there are formal procedures for consultation on a continuing basis. The process is constructive, providing the relevant Committees of the Congress with the full opportunity to express their views, and providing us with the opportunity -- and the discipline -- to explain our policies and the reasoning behind them. At the same time, there is ample opportunity to discuss our policy problems and objectives with the Administration in power, and to convey our thinking to them. Obviously, policy differences can arise, large or small. But in the end, I would doubt, to understate

the point, that the country would be well served by subordinating the interests of monetary policy to that of the Executive.

I understand -- indeed to a degree, I share -- the longing of some to encompass the objectives for monetary policy in a simple fixed operating rule that can be debated and set in place for a long period of time. The trouble is, right now, in the world in which we live, I know of no such simple rule that will also reliably bring the results we want -- be it short or long-term interest rates, real or nominal; the price of gold; an exchange rate; or the value of a basket of commodities.

But, after the hard experience of the past ten or fifteen years with accelerating inflation, I believe that we have learned one basic rule that must be observed: the forward progress of the economy over time is dependent on a sense of price and financial stability. Without that, the kind of sustained growth and employment we all want is all too likely to founder on financial disturbance, high interest rates, and speculative imbalance.

That concern requires that, in our policy-making today, we keep a clear eye on the potential future implications of the process of money and credit creation. Even though those implications may not be immediately apparent, excessive growth of liquidity would, in time, be the enemy of the lower interest rates and stability we need.

I need not dwell on the fact that we are negotiating a most difficult period in our nation's economic history. With production falling into sharp recession, the unemployment rate has risen to a postwar high. Too large a share of our industrial capacity is idle. Profits are depressed, agricultural income is squeezed, and there have been exceptionally large numbers of business failures. Conditions in most other industrialized countries, in greater or lesser degree, have paralleled those in our own economy, and forceful measures have been needed to deal with acute economic problems in large sectors of the developing world.

At the same time, out of this turmoil and stress we can see elements of change and returning strength that bode well for the future. In particular, striking progress has been made in reducing inflationary pressures. The measured rate of inflation in 1982 was the lowest in a decade, and forces are at work that, carefully nurtured, can continue that progress during recovery. That achievement has laid a solid base for a substantial and lasting reduction in interest rates from the record high levels of the past couple of years. As confidence builds that inflation can continue to be held in check, further declines should be sustainable. Business and labor have responded to the market forces by taking measures to cut costs and improve efficiency, and those measures should have a healthy effect long after the recession has passed.

At the turn of the year, signs appeared that the decline in economic activity was ending and that recovery might soon develop. Housing construction, new orders, retail sales and production all have shown some improvement in recent months. The indications of some firming in labor demand are heartening.

I know that this past year or two has been for many a time of frustration and doubt. Unemployment of a willing worker is always a threat to personal and family stability; on a wide scale it is an affront to our sense of social justice. To a generation grown accustomed to accelerating inflation, a year or two of progress toward price stability simply hasn't yet been enough to quell fears that the earlier trend will resume as the economy picks up speed. We have been disappointed before when early signs of recovery faded away. Federal deficits persisting at levels beyond any past experience are unsettling to more than financial markets. We have been jarred to the realization that a serious international financial disturbance is not just something we read about in books of economic history but could recur unless we are alert to the dangers and deal aggressively with them.

Uncertainty and confusion are perhaps inevitable in a period of change -- even constructive change. But they can easily be destructive without a clear conception of where we

want to go and how to get there. My conviction is that there are solid grounds for believing the signs of incipient recovery can be the harbinger of performance much more in line with our goals of growth in employment, output and productivity at relatively stable prices.

I fully realize that the striking progress against inflation does not mean the battle is won. The gains have been achieved in the midst of recession, with strong downward pressures on prices and costs from weak markets. We cannot build a successful policy against inflation on continued recession. The question remains as to how prices will behave as the economy recovers -- after six months or a year of rising orders, employment, and production.

In one respect, the outlook is plainly much better than in the inflationary decade of the 1970s. The single commodity of major importance to the general price level -- oil -- is in surplus supply, and the price in real terms has been declining. I cannot prophesy the point at which the price of oil will settle down in coming weeks or months. But barring a major political upset, prospects appear exceptionally good for stable or falling real prices for finished petroleum products -- which account for 8-9 percent of the GNP -- for some time ahead. Because petroleum prices led the inflationary process in earlier years, the change in trend has symbolic as well as substantive significance, driving home the point that prices are not a one-way street. We also have large stocks of basic food commodities, providing some assurance against a sharp run-up of prices in that area.

But it is labor costs that make up the bulk of the value of what we produce -- accounting for about two-thirds of all costs. Our success against inflation in the longer run will need to be reflected in the interaction of wages, productivity, and prices. It is also in this area that recent signs of progress can potentially prove most lasting.

The upward trend of nominal wages and salaries slowed noticeably last year, with total compensation rising just over 6-1/2 percent from the fourth quarter of 1981 to the fourth quarter of 1982. Moreover, the trend during the year seemed to be declining, and in the midst of pressures on profits, markets, and employment, could well show further declines. The sharply lower inflation figures -- rising more slowly than the rate of wage increases for the first time since 1978 -- moderate one source of upward pressures on new wage agreements. Longer-term union agreements negotiated in earlier more inflationary years are expiring, tending to further moderate the wage trend.

The slower increases in nominal wages have been fully consistent with higher real wages for the average worker precisely because the inflation rate has been declining. Continuation of that benign interaction among lower inflation, lower nominal wages, and higher real wages -- combined with recovery in profits -- must be a central part of a non-inflationary recovery, and thus to sustaining expansion.

Those prospects will be greatly enhanced by improved productivity performance; over time, only an increase in productivity can assure higher real wages and profits. Happily, after dwindling away to practically nothing during the 1970s, there are now signs that the trend of productivity is rising once again. The statistical evidence is consistent with widespread reports from business that significant progress has been made in improving efficiency and in reducing "break-even" levels.

During the early part of recovery, productivity usually grows more rapidly than in recession. Consequently, a combination of rising cyclical and "trend" productivity with more moderate nominal wage gains should reduce the increase in unit labor costs further as we look ahead. For example, a rise in hourly compensation of less than 6 percent this year would appear consistent with recent trends. Should productivity increase by only 2-2½ percent -- an expectation that would appear modest in the light of recent experience -- unit labor costs would rise by significantly less than 4 percent, low enough to maintain and reinforce progress on the price front.

As confidence grows that the gains against inflation are sustainable, the possibility of further declines in interest rates -- and particularly long-term interest rates -- should be strongly reinforced. Today, interest rates, despite the large declines last year, remain historically high in nominal terms and measured against the current rate of inflation. A number of factors contribute to that, including the present

heavy Treasury borrowing. But, after long years of disappointment on the inflation front, concerns that recent progress toward stability may prove temporary have certainly been one important force checking the decline in interest rates.

We will certainly need higher levels of investment and housing as time passes to maintain productivity, to support real income gains, and to keep supply in balance with demand. In a context of reduced inflation, lower interest rates will be a key to future performance in those areas. And what is essential in that respect is that lower interest rate levels are not just temporary, but can be sustained over time. That is one strong reason why policies need to remain strongly sensitive to the need to maintain the progress against inflation -- uncertainty on that point will ultimately be self-defeating in terms of encouraging the market confidence and the interest rate environment we want.

An improved climate for work, for saving, and for investment -- the objective of the tax changes introduced in 1981 -- should also materialize in an economic climate of recovery and disinflation. All of that can help support a continuing process of productivity improvement and restraint on costs. Rising real incomes should be reflected in consumer demand -- an area of the economy already supported by the large deficits and a clear improvement in the liquidity and debt position of the average family. As living standards rise and fears of inflation fade, pressures for excessive and "catch-up" wage demands should subside.

In sum, there are strong analytic reasons to believe that the incipient recovery can develop into a long self-reinforcing process of growth and stability. But we cannot afford to sit back, confident that the natural course of events will produce that result. There are too many obstacles to be overcome to afford any complacency. If we are to turn our economic potential into reality, we must deal with those threats; the more firmly we move -- by action now and by setting ourselves clear guidelines for the future -- the faster we can end the doubts and restore the confidence necessary to success.

The most obvious obstacle that looms ahead is the prospect of huge Federal deficits continuing, even as the economy expands. I, and many others, have spoken to this point repeatedly. There is no need to repeat the arguments in detail here. Suffice it to say the present prospect of deficits at \$200 billion or so continuing into a period of falling unemployment, when private credit demands will rise, is simply inconsistent with meeting our needs for investment and housing. The threat that the Federal Government will preempt a high fraction of our total savings potential in a period of growth -- a far higher fraction than in the past -- throws into doubt the prospects for lower real interest rates, progress against inflation, and ultimately sustaining the expansion.

The challenge is known, and broadly measurable. It cannot be dealt with by money creation. But it is also clearly within our capacity, over several years, to make the necessary changes. The time to start is now.

We also must be conscious of the fact that the risks and uncertainties in the present situation are compounded by the fact that so much of the world is in recession, and adverse trends in one country feed back on another. One result has been that our own trading position has deteriorated, and declining exports have contributed importantly to the severity of our recession.

It is tempting, here and elsewhere, to try to cope with the problem by retreating within ourselves, insulating our economies by protectionist measures. But such measures, spreading through the world, are bound to be mutually self-defeating in terms of economic expansion, and protectionism can only complicate the inflationary problem.

In this area, like so many others, the United States, like it or not, is the bellwether for the world. If we abandon our principles of open markets, others will follow, and probably more fully and effectively. It's a process none would win.

Today, we have faced another, even more immediate, threat in the international area. The potential for financial disturbances flowing from the debt problems of a number of developing countries at a critical point in our recovery has been real. Nor could we expect to confine those disturbances, should they arise, to the international area alone; the same institutions are important in our domestic markets.

I firmly believe the major international borrowers and lenders, with the understanding and support of Governments, central banks, and international institutions, can face up to and deal with those problems constructively. But the cooperative

pattern we have seen emerge in managing these problems is absolutely dependent on the capacity of the International Monetary Fund to continue to play a key role at the center of the international financial system. Early Congressional approval of the enlargement of IMF resources will be essential to that effort.

Finally, there is a more insidious risk that attitudes of business, of labor, and of the public at large could revert to habits of thinking and policies encouraged by years of accelerating inflation, but out of keeping with the kind of economic environment that now seems to be emerging. I have already described the pricing restraint and the trend toward more moderate increases in wages that have developed in the midst of recession. As best I can assess it, the mood today is consistent with maintaining that momentum. There is realization that competitors at home and abroad have large potential capacity, and after all the efforts to cut "break-even" levels, expanding volume can in many instances itself produce satisfactory profits as well as larger employment opportunities. The "smokestack" industries, hit so hard in the period of recession while already faced with the need for structural change and with particularly high wages by domestic or international standards, have particularly strong incentives for caution.

But there is, of course, another possibility. Business and labor -- still sensitive to the failure to sustain past efforts to restore stability, and eager to restore price or wage "concessions" -- may be tempted to test their bargaining and pricing powers much more aggressively as orders and production

expand. If they were to do so, sensitivities of consumers and financial markets to the possibility of reinflation would only be aggravated, tending to keep interest rates higher and greatly increasing the difficulty of maintaining the economy of a non-inflationary path of growth.

This is an area where government policy can help directly to minimize the danger -- by resisting protectionist pressures and by removing or relaxing obstacles to competition in domestic product or labor markets. Areas of the economy that have seemed almost impervious to the disinflationary trend and market pressures -- such as health care and higher education -- seem to me to deserve special attention.

Through all those particulars, however, restraint in price and wage setting can reasonably be expected only if government financial policy remains plainly oriented toward containing inflation. Without a sense of conviction on that score, the temptation to jump ahead of the pack -- to anticipate the worst -- as employment and orders are restored may become irresistible. The fact is moderation in pricing and wages will be consistent with higher real wages, profits, and employment over time. But the individual firms or workers will see such moderation as in their own interest only if they can reasonably count on the trend toward stability being maintained -- and that will require a framework of financial discipline.

The skepticism that had been built up over many years about the resolve to deal with inflation has been reduced but not eliminated. There is little or no leeway at this stage for "mistakes." Policies designed with the best will in the world to "stimulate," but perceived as inflationary, may, unfortunately, produce more inflation than stimulus.

It is in that broad framework and context that monetary policy has been implemented in 1982 and that we in the Federal Reserve look ahead to the current year and beyond. Monetary policy is concerned with providing enough money and credit to meet the needs of recovery -- but with the need to build on the progress against inflation. The line is a narrow one; it cannot be determined with mathematical precision.

The fact that relationships between money and credit, on the one hand, and economic activity and prices, on the other, deviated substantially last year from earlier norms has only complicated the job. Institutional change in the financial world is an indisputable fact, and the resulting distortions in the patterns of monetary growth have been one factor in those deviations. Potentially more important over time, the process of disinflation itself, the uncertainties surrounding recession and financial strains, and changing interest rate relationships can, either temporarily or more permanently, change the appropriate growth path of money. All that needs to be sorted out; the need for judgment is inscapable, because we can know for sure only long after the event.

I will not take the time to review our precise monetary and credit targets for 1983 today in all their technical complexity. But I will say to you that, in arriving at those judgments, we have been fully conscious of the basic continuing objective of fostering a trend toward price stability in the conviction that that environment is compatible with -- indeed essential to -- sustaining the economic growth and lower interest rates we would all like to see.

I believe it is also fair to say that, in making those judgments, we have benefitted from being able to draw upon the resources of the Federal Reserve System as a whole and the strength of its unique institutional structure.

Today is a special and festive occasion in the life of the Fed. A fine new building reminds us of our roots. By its nature, it is also a symbol of our faith in the future. Of course, we have been through a difficult period. Plainly, there are obstacles ahead. But equally obviously, challenges we know are challenges that we can meet.

We have within our reach a self-reinforcing process of growth, higher real incomes, and expanding employment opportunities -- a process that has eluded us for too many years. Now, I believe we can as a nation grasp that opportunity.

That great new pile of stone and mortar on Market Street combines architectural merit with the promise of operational efficiency. But, I also hope it will stand through the years for something less tangible but more important -- a symbol of the continuing resolve of the Federal Reserve to do its part in making the bright potential of our free economy a reality.

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