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We Can Survive Prosperity

Remarks by

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at the

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Economists, by profession, have a well-earned reputation for nay-saying. The "dismal science" is built around the simple proposition that burgeoning desires exceed limited means -- that we can't have everything, certainly not all at once. I suppose central bankers have a reputation for preaching that lesson to the extreme. It seems to me ironic, under the circumstances, that economists are wont to meet together in the midst of the holiday season -- and then to invite a central banker to address you.

Of course, on this particular occasion, looking backwards, we all have a good deal to cheer about. Not, on the record, about our capacity to forecast. But it is pleasant, for once, to find things turning out significantly better than almost all had anticipated, measured both by rising output and employment and by less inflation.

The last reported statistics summarize the story: unemployment down more than 2 percentage points from the peak; industrial production up 16 percent in twelve months; no increase in producer prices and only a 0.3 percent increase in consumer prices in November, one year into recovery. Certainly, those data provide a happy contrast to other recent years.

We also know that any sense of ebullience over those numbers must be tempered by knowledge of what came earlier: one of the longest and deepest recessions of the postwar period. We have indeed been experiencing a sharp business

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recovery, consistent with progress against inflation. But excess capacity of both men and machines here and abroad has helped restrain prices. In a sense, that cyclical phase is the easiest part, and it's about over. The issue today is not the past but the future. Can we negotiate not just recovery, but lasting expansion -- an expansion that will bring in its train the rising real incomes, the investment and productivity, and the sense of stability, that we want?

My thesis is simple. We now have a rare opportunity -- an enormous opportunity -- to set in train a long period of growth and greater stability. A decade that began with the heritage of accelerating inflation and soon fell in the slough of recession -- developments that seemed to make a mockery of the bright hopes and expectations of economists ten or fifteen years earlier -- can end with renewed confidence and strength. To put the point another way, we can reverse the experience of the 1970's -- we can demonstrate that an economy that seemed to be going downhill, with one adverse shock begetting another, can go up as well.

I am not about to suggest that happy vision will somehow come about by itself, that we can now sit back and let events take their course, counting on a hope that the recent good news will produce a lasting momentum of its own.

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After all the difficulties and disappointments of the past decade, that kind of optimism doesn't "wash" today -- understandably so.

But I do not share the doubts and skepticism of many -- indeed the deep cynicism of some -- about our capacity as a nation, to learn from bitter experience and draw practical lessons for the future.

I fully realize there are some new and unprecedented threats and risks to sustaining progress -- the enormous budget deficits, the international debt problem, the gaping and still growing imbalance in our international accounts, the strong forces of protectionism, and, not least, the temptation to return to behavior patterns bred in the years of inflation. But those threats are not exactly hidden -- and once understood, they can be met.

And, we also have in place some elements of a strong start:

- Most importantly, for the first time in many years, the rate of inflation has been ratcheted down.
- That progress is undergirded by greater restraint on underlying costs in most sectors, accompanied by signs of more emphasis on efficiency and productivity.

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- There is a strong sense that major industries and markets are and will be under greater competitive pressures than before, both because of less regulation and the intensity of international competition.
- We can see the beginnings -- no more than that -- of a rebuilding of corporate balance sheets, of a strengthening cash flow, of a return to levels of profitability more normal historically, and of an improved climate for risk capital and innovation.

The obvious need is to build on that progress while dealing with the threats.

Easy to say; hard to do.

The greatest challenge of all, in my judgment, is to face up more openly and directly to the need to find ways to combine continuing growth with continuing progress against inflation. Sometimes we seem to be so steeped in analysis that suggests it is hardly possible that we almost refuse to think about it. Yet, we also can sense that once we accept an inflation tradeoff, the inflationary process will tend to accelerate, and ultimately defeat growth as well.

Obviously, the effort to restore reasonable price stability does not mean we need to make progress toward a zero price statistic every year. Our various price indices are not so refined -- and never will be -- that a change of

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a point or so over a particular year is meaningful. Different measures may show different results, as during 1983. Important "shocks" at home or abroad can disturb a trend or upset an equilibrium. Cyclical changes in the degree of pressure on capacity and labor markets will usually be reflected, with a lag, in cyclical changes in prices. Specifically, the months of virtual stability in producer and consumer prices during the early part of this year, in the immediate aftermath of the recession and the decline in oil prices, should not, and were not, expected to persist through a vigorous upswing. Nor would small cyclical effects on prices in 1984 necessarily be inconsistent with extending a trend toward greater stability over time.

A workable definition of reasonable "price stability" would seem to me a situation in which expectations of generally rising (or falling) prices over a considerable period are not a pervasive influence on economic and financial behavior. Stated more positively, "stability" would imply that decision-making should be able to proceed on the basis that "real" and "nominal" values are substantially the same over the planning horizon -- and that planning horizons should be suitably long.

To some, that objective has a moral content -- it is a responsibility of government to provide "honest money." I will not debate that point -- I am addressing a convention

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of professional economists, not moral philosophers or political scientists.

Analyzing the issue as a matter of economic engineering, I believe that the experiences of the 1970's here and abroad have demonstrated the practical difficulties of sustaining growth and productivity on the shifting sands of a progressively weakening and uncertain currency. The Phillips Curve that looked so persuasive when based on historical data without a long-term inflationary trend turned out to be unstable over time when policy was heavily influenced by the implied premise that we could "buy" prosperity with a "little" inflation. In time, unemployment trended higher, even as inflation accelerated to the point where it became seriously distorting, with expectations at the end outrunning even the reality.

I realize sophisticated arguments are made that a steady, relatively low rate of inflation can be tolerated as a kind of background noise that, because it is generally anticipated, will cause few distortions. I don't know of any precedent in this country for that kind of "steady state" inflation -- indeed, psychologically, I suspect it is a contradiction in terms. The natural tendency for inflation -- once accepted -- seems to be for it to rise on the simple premise that a government or a nation ready to tolerate a "little" inflation will always be prepared to tolerate a little more.

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For now, to some degree, that insidious pattern has been broken; the recent progress in bringing inflation down is reflected not just in price statistics but also in the evidence we have about expectations and behavior patterns. But plainly the job is not complete -- far from it. The years of inflation and failed anti-inflation programs have understandably left deep scars, not least among those responsible for investing money. As the economy grows, as jobs are easier to find, and as profits return to more normal levels, there will be stronger temptations to anticipate inflation in pricing and wage decisions -- it is symptomatic that some wage contracts that keep up with recent inflation are labeled "concessional." Economists are aware that deceleration of inflation during the first year of economic recovery is not unusual -- that the progress is more typically reversed in the second year of expansion, with further acceleration expected before the next recession.

The question, of course, is how to change that pattern -- how to maintain the progress against inflation while maintaining growth during the transition period toward stability.

Certainly, I would accept, with most of you, the simple proposition that success in the effort against inflation requires appropriate restraint on the growth in money and credit. In that sense, monetary policy is at center stage. Ultimately, money should increase no faster than the needs generated by

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real growth at reasonably stable prices. But I think we have to recognize, too, that such "appropriate" restraint on growth in money and credit -- while unambiguously effective in the end in curbing prices -- can in the real world collide with the needs for money and credit generated by a combination of rising economic activity and the momentum of an established trend of rising prices. In such circumstances, as we have seen, the result can be abnormally high interest rates and adverse consequences for employment and growth.

The point is sometimes made that the prospects for any such "collisions" will be greatly diminished if expectations -- and thus behavior patterns -- adjust more quickly to prospects for greater price stability. The much debated question of the "credibility" of monetary policy is relevant to this question.

Some have argued that the Federal Reserve can achieve the necessary credibility -- in the sense of quickly changing expectations -- only by an unambiguous commitment to some simple and fixed rule. Suggestions are made to preset a narrow growth path for some monetary aggregate for years ahead, to defend a particular price of gold, to enforce stability in the price level of a basket of commodities, or perhaps to target a gradual reduction in the growth of nominal GNP to a rate consistent with our capacity for real growth. The appeal is obvious; if only we could be fully convincing that we have found a certain path to the promised land, and we

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stick to it through thick and thin, the natural forces of the marketplace will work toward our objectives, speeding their achievement.

We can find instances in history, usually after hyper-inflations or savage depreciation of a currency externally, when a dramatic national commitment to a new standard did, indeed, seem to help in speeding restoration of stability. These programs were not painless; they were typically accompanied by strong action to close budgetary deficits and to achieve structural changes in the economy; and they were undertaken in a context of perceived crisis, political and economic, when extreme measures were widely accepted as justified.

That strong sense of crisis may be lacking today. But the need remains to convey a sense of conviction -- a conviction that is expressed not just in words but in action. To the extent rules and guidelines, set out in advance and widely understood, can help us convey our intentions and discipline our decisions, we should be sympathetic to them. And, in that context, the recurrent debate about which rule is best can be healthy.

Important technical judgments are involved. But it is not just a technical question to be answered by internal or academic research. The effectiveness of any rule in affecting expectations will depend, in the end, upon the basic logic as perceived by the public at large. In that sense, the

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emphasis in recent years on targeting of money and credit growth has been justified by wide public and Congressional understanding, as well as a long history of more technical analysis and research.

That experience has also suggested, however, some of the potential pitfalls in relying too slavishly on a narrowly defined rule. Quantitative rules for money depend upon our ability to maintain a fixed definition of money over time, and upon a certain predictability in velocity, if not for periods as short as a quarter or two, then for a year or longer. But in the midst of rapid change -- institutional or economic -- we know the relationships among any specific measure of money and economic activity and prices can shift quite significantly in the short run, and the underlying trends may change as well. The years 1982 and 1983 showed just such shifts, beyond the range experiencaed earlier in the postwar period. There are some signs today that more normal patterns may be reasserting themselves, but only time can confirm the point.

Other possible "targets" appear to have comparable or greater deficiencies today. Technically, we do not know, within a wide margin, what gold price would be consistent with progressive stabilization of the general price level, or whether stabilizing a basket of commodity prices at current levels would indeed be consistent with more general price stability. Imposing a rule of uncertain technical validity

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that had little understanding or support by the public could easily be counterproductive, undermining rather than supporting credibility over time. I need not remind you in that connection that it was only a little more than a decade ago that the United States departed from its commitment to a fixed price of gold after much of the economics profession, rightly or wrongly, had come to question its rationale and thus undermine its legitimacy.

In sum, I do not believe we can bootstrap our way to combining price stability with growth simply by committing ourselves at this stage to a mechanical rule. There is more to it than that. Confidence will be built and maintained as a result of demonstrated progress toward stability, and that progress will be speeded by a clear consensus on the validity, and the reality, of the objective.

The decision of the Administration, preparatory to its annual economic and budgetary messages, to project declines in the inflation rate after 1984 should contribute to that consensus. Of course, such medium-term projections, to be meaningful, must provide a base for, and be consistent with, actual policy formation. One implication, among others, of achieving further progress toward stability is that growth in nominal GNP and money and credit will need to be reduced over time.

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For reasons I have already suggested, I do not believe an attempt to schedule reductions in the money supply with precision, year by year for several years ahead, is useful. But I do believe that both our policy decisions in the Federal Reserve, and your expectations, should be strongly conditioned by that broad objective and strategy -- I am tempted to say by that "general rule."

The question remains as to how long a transition period is required for reduced monetary growth to work toward price stability, and whether that transition will be consistent with satisfactory economic growth, rising employment, reasonable profits, and -- given the weight of the American economy and financial markets on the international scene -- a healthy world economy. The answer to that question lies in major part on circumstances outside the control of monetary policy. Those circumstances will also inevitably bear on the ease or difficulty of maintaining appropriate monetary policies.

Obviously, the state of the Federal budget is one case in point. Large deficits, currently and prospectively, are a burden on credit markets and absorb historically unprecedented fractions of our domestic savings. That is one reason interest rates today are far higher than is healthy from the standpoint of balanced growth domestically. From an international perspective, the problems stemming from high interest rates are still more pressing. The level of dollar interest rates

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plainly aggravates the strains on the international financial system -- strains apparent in the heavy debt burdens of many developing countries and in the persistent and growing flow of capital into the United States, with its counterpart of a widening trade deficit.

The basic outlook and its implications for the United States and other countries are too familiar for me to linger over today. Suffice it to say that I do not share the comfortable assumption of some that working -- forcefully and steadily -toward better budgetary balance is a task that can wait a year or more.

With nominal interest rates so far above observed inflation, a natural expectation should be for interest rates to fall. But the burden of the Treasury financing works in the opposite direction, both directly in the marketplace, and by helping to maintain inflationary expectations at a higher pitch. We, in all our sophistication, can try to explain to the American people that in the end it is money creation, not deficits, that feed inflation. But I am afraid they have a strong instinct -- and there is a lot of experience around the world -- that the two often go hand-in-hand.

The Federal Reserve ultimately is indeed capable of avoiding excessive increases in the money supply. What it cannot do is create the savings necessary to support both a large deficit and high investment or relieve the pressures on

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interest rates implicit in an approach that leaves so much of the burden for containing inflation to monetary policy alone. To achieve price stability in the midst of prolonged market strains, low levels of investments, and a stop-start economy would be a hollow "victory."

As important as Federal financial policies are, they are far from the whole story. There is the question as to whether the strong efforts to cut costs and increase efficiency, first born in recession, will carry into the expansion process.

Can, in fact, the new sense of discipline survive prosperity?

On the encouraging side, we can point to significantly lower average nominal wage increases, and to the fact that over the first three quarters of 1983 large collective bargaining agreements had first year wage settlements averaging only 1.7 percent, the lowest since the data began to be collected in the mid-1960's. But the statistical evidence is still ambiguous.

I know some knowledgeable analysts of labor markets remain deeply skeptical about whether there has been lasting change in fundamental behavior patterns and expectations developed out of earlier experience -- patterns that, once established, tend to maintain an inflationary momentum. They point out sharp reductions from the earlier trend in nominal wages have been largely centered on industries under intense market pressures. About half of the large new settlements,

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in industries where the recession did not bite so hard, ran to 6 percent or more, only moderately below the earlier trend. Settlements of that magnitude -- which have been characteristic of utilities, finance, and other important industries -- at the moment imply large increases in real income, but, if generalized, would place a rising floor under costs.

Concerns of this sort in the past have often led to a call to impose discipline by an "incomes policy," involving governmental norms for wage and price increases. But neither the past record nor the public mood suggests that is a practical, or desirable, approach.

But I do believe we can see signs that a more competitive marketplace can produce a more viable sort of "incomes policy" of its own. Trucking, airlines, communications -- each a large growth industry that had been sheltered from competition -- have had to adjust in a way without parallel in the postwar period. Other industries long characterized by relatively high cost and wage structures have found themselves particularly vulnerable to the ready availability of goods and aggressive pricing from abroad.

I know some of that pressure is exaggerated currently by the exceptional performance of the dollar, and there are dangers of a strong protectionist response. But I suspect

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that such fundamental forces are at work that the United States is likely to remain a far more open economy than ever before. And, there should be no excuse for maintaining the barriers to competition that now exist -- whether reflected in quotas on imports or in domestic legislation -- in the absence of restraint on costs and wages.

Appropriate public policies in these areas can, I believe, help nurture an environment in which discipline can be maintained.

In the end, that environment will have to be reflected in new attitudes and new approaches permeating a whole range of private decision-making, approaches rooted in our own market system and political environment. In that connection, I welcome the new interest in profit-sharing arrangements or other ways of rewarding workers when things are good, without building in an inexorably rising floor on costs. The concepts of quality circles, experimentation with worker representation on boards of directors, methods of encouraging employee stock ownership, and other initiatives -- often born in adversity -- carry promise for changing the confrontational nature and brinkmanship characteristic of so much of our industrial relations.

My basic point is that our economy will not work well for long as a house divided -- with a monetary policy designed to restore stability, but with other policies -- public and private -- inflating credit demands, building in strong cost

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pressures and imposing a high degree of rigidity in labor or product markets. I believe we have learned, from hard experience here and elsewhere, that no lasting solution to such an impasse can be found by simply turning on the monetary valve, further entrenching the inflationary process.

I suspect nearly all of you would accept those generalizations. But still, after the long years of inflation, there is also a great timidity in accepting the implications, in setting our standards high, in supporting with vigor the measures that can help reconcile growth with stability. We often seem almost oblivious to the fact that through long stretches of history, inflation was not a way of life, and need not be now.

We have, as I argued a few moments ago, gone a long way toward changing the trends of the past decade and more. We can build on that base.

In all of this, monetary policy has an indispensable role to play. And it is right and proper that our actions should be tested and debated in the crucible of professional scrutiny. But I also hope that emphasis on monetary policy will not lead to neglect by the economics profession in investigating and emphasizing what is necessary, in other public and private policies, to deal with the tradeoffs in reconciling growth and stability that we are so fond of describing.

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A successful effort will in the end need to rest on a national consensus that the goal is in fact valid and obtainable -- that over long periods of time a sense of stability is essential to lasting growth.

As Patrick Henry might have said, were he an economist today, if this be economic heresy, then make the most of it. It is the way the economy is supposed to work. We can make it work that way again.

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