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Opportunities and Dangers

Remarks by

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at the

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It's a special honor to be asked to come to Wake Forest and to renew the Broyhill Executive Lecture Series that was started in 1980 by President Ford. And it's particularly nice to be introduced by Louise Broyhill, with her special family and University relationships! Perhaps I should also say it's really a necessity for those of us in Washington to get out once in a while and see how the country really lives, and what it's really thinking. In a sense, I suppose that ability to bridge the reality of your world and the world of Washington is what the Congress is all about, and it's a special delight to have members from both sides of the aisle -- Jim Broyhill and Steve Neal -- here today. They personify the Wake Forest, North Carolina, Washington, D. C. axis!

Now, I may be from Washington, but I well understand there are certain other preoccupations on the campus today. I'll stick to economics. I assume there is plenty to talk about -- but I promise to finish before 10:30.

There is a lot to cheer about as we look back at the last 15 months. Unemployment has dropped nearly 3 percentage points, industrial production is up almost 20 percent, the inflation rate has slowed appreciably, and -- not unrelated -- real wages, on the average, are rising more rapidly and consistently than for many years.

That's quite a record, but I realize these gains have followed one of the longest and deepest recessions of the postwar period; the gains we are seeing have not been won

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without great pain and difficulty, and they are not spread evenly around the country. And I am not about to suggest we can afford to rest on our oars now.

I do think we have a new opportunity -- a kind of launching pad -- for placing the economy on a more sustainable orbit of growth and stability. That's a trend that has eluded us for almost two decades -- essentially for the lifetime of those of you in college today. But there are also obvious threats and obstacles to that bright prospect. And I'd like to talk a bit about both -- the opportunities and the dangers.

We have been in the midst of a battle against an inflationary momentum, and patterns of thinking and behavior bred by inflation that became ingrained. To put the point in some perspective, something like half of our working population -- those under age 35 -- have never known price stability during their working and consuming lifetimes -- and only have begun to get a taste of it recently. During the late '60's and '70's, Americans increasingly began to count on inflation as part of their everyday life -- they expected it to continue, and those attitudes came to be reflected in behavior. Workers came to think of large wage and salary increases of 10 percent or so as the norm. Businesses anticipated inflation in their pricing policies. Bonds and other fixed-interest securities got a bad name as investments, and many people turned to real estate or gold or diamonds to protect their assets. The rewards

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from speculation seemed better than worrying about efficiency and productivity -- and we began to count on inflation to bail us out of bad business or investment decisions. All that helped to keep the process going -- and, in retrospect, it's understandable productivity growth practically disappeared, and as the economy became distorted, unemployment trended higher.

During that period, we saw several efforts to combat inflation -- efforts launched with sincerity and real concern. But those efforts were defeated or abandoned prematurely, in whole or in part, when they seemed to conflict with other objectives. The whole inflationary process began to take off in the mid-1960's when, as a nation, we tried both to fight a war and to introduce a "Great Society" without facing up to all the costs. Policies of restraint in the late 1960's were not pressed for long. By 1971 we turned to mandatory wage and price controls. The apparent gains from that program were soon washed away. The energy crisis -- and for a while bad crops -- accelerated the process.

There were later examples of policy responses to inflationary concerns, particularly by monetary policy, but the hard fact is fiscal and monetary discipline was not pressed long enough to turn the tide. Instead, the conviction grew that each cycle of economic activity would leave us with a residue of still higher prices.

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But it was also true that, by the late 1970's, the costs were becoming more apparent. Inflation, after it has been around awhile, feeds on itself -- as I suggested a moment ago, expectations of inflation, strongly enough held, are reflected in behavior that perpetuates and accelerates the process. As that happened -- and inflation for a short time moved to the 15 percent range -- there was a justifiable sense of alarm. The consequences, including historically high interest rates, became more noticeable. A lot of people began to observe that, contrary to much earlier doctrine, as inflation continued, unemployment tended to rise and economic growth to slow.

As this decade began, you could sense a growing commitment among the American people that the time had come to deal decisively with inflation. I think there was also a realistic appreciation that sudden, painless solutions were not possible, but that failure to face up to the job would ultimately entail much heavier costs.

Many economists used to argue that "a little" inflation may be a good thing -- a benign kind of "social solvent" useful in resolving too many competing claims for a limited amount of real output, and a kind of stimulant to investment. And there may have been an element of truth in those propositions when the norm was stability, and a little inflation was a surprise. But the old adage about "you can't fool all the

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people all the time" applies in this area, as others. And once inflation picked up speed and became ingrained in thinking, the game was up and we learned the economy doesn't operate very well without a sound financial yardstick -- a stable dollar.

What is past is prologue, and I have just described a rather dismal prologue to the 1980's. But we can also learn from experience, and those lessons are one important reason I can be so hopeful for the future -- why, after a deep and prolonged recession I believe we have a rare opportunity to set in train a long period of growth and stability. 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 by itself, that we can now sit back and count on the recent good economic news producing a lasting momentum of its own. After all the difficulties and disappointments of the past decade, that kind of optimism doesn't "wash" today -- understandably so.

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

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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. Before addressing those threats directly, let me emphasize why I think we can build on the progress of the past year or so.

- Most importantly, for the first time in many years, the rate of inflation has, in fact, been ratcheted down. Prices are still rising -- but at the lowest rate in a decade or more.
- We paid the price of recession in breaking the inflation momentum. But prospects for better performance as the economy grows are undergirded by greater restraint on underlying costs in most sectors, accompanied by signs of more emphasis on efficiency and productivity.
- 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. Those pressures are often uncomfortable, to say the least, but they are also an enormous stimulant to efficiency and innovation.
- Meanwhile, as the economy grows, we can see the beginnings of a rebuilding of corporate balance

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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.

Now, with unemployment declining rapidly for more than a year and with capacity more fully utilized, we face a critical period in terms of keeping the process of expansion going not just in 1984 but in the years beyond. Stated another way, we have the challenge of combining growth with continuing progress against inflation, because without the latter we will, in my judgment, undermine the former. Despite all the recent progress, I know there is a lot of skepticism -- even cynicism -- about whether it can be done.

In a few areas capacity is already coming under pressure. Recently, food prices reflected the effects of bad weather. That, in itself, should be temporary, but a rising consumer price index for even a few months can affect thinking and expectations.

To some degree, prices will always reflect the stage of the business cycle. An inability in 1984 to repeat the exceptionally good performance of 1983 should not, at this stage of expansion, in itself be a cause of great concern -- so long as change is small.

What will count is whether, over reasonable periods of time, our policies point toward prospects for greater stability,

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not less. In my judgment, we cannot be satisfied until we have reached the point when people can begin to take for granted that a strong and persistent acceleration in the general trend of prices is not in the cards -- that in their financial planning, they do not constantly have to be "on guard."

The memory of years of inflation and failed anti-inflation programs have understandably left deep scars, not least among those responsible for investing money. That is one important reason why interest rates have remained so high in historical terms. Assuming we can maintain the progress against inflation, those interest rates should over time move lower -- and it's important that they do so if we are to sustain housing, encourage investment, and contribute to a strong world economy. But it is precisely the concern about my assumption -- that inflation will be kept in check -- that is at issue in the minds of many investors and savers.

Certainly, I would accept the simple proposition that monetary policy, in the end, will have a lot to do about the inflation outlook. Over time, the lesson of history is that success against inflation requires appropriate restraint on the growth in money and credit, year after year. Ultimately, money should increase no faster than the needs generated by real growth at reasonably stable prices. Given the degree of price increases still "built in," we are necessarily some distance from that point. But the goals we have set for

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ourselves for 1984 are designed to make further progress in that direction.

This is not the time or place for a long technical discussion of exactly how fast money should grow, and all the influences that bear on our judgments in making monetary policy from month to month. Suffice it to say our targets for money and credit growth this year have been designed to allow for further significant growth in the real economy -- say at a rate of about 4-5 percent -- so long as prices do not accelerate much. Early in the year, we have been doing even better, and from what I have seen of the views of others, there is a wide range of agreement that our goals are appropriate and feasible.

We will, of course, continue to assess our targets in the light of what is happening -- most fundamentally in terms of growth and general price trends, but also keeping an eye on such factors as the exchange rate, developments in domestic and international financial markets, and other considerations. We are conscious that relationships between money and what we really care about -- growth and prices -- are not invariable; in fact, they deviated quite widely from historic norms in 1982 and 1983. But neither can we afford to lose sight of the need for continuing discipline lest we inadverently squander the chance to restore stability over the long run, as too often has happened in the past.

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Nor can we, through any conceivable manipulation of the money supply, combine a smooth path of economic growth and moderate interest rates with progress toward price stability if other areas of the economy, or economic policy, are out of balance or unstable. And we don't have to look very far to see some points of danger.

Obviously, the state of the Federal budget is one case in point. Historically large deficits, currently and prospectively, are a burden on credit markets. They absorb an unprecedented fraction of the savings we are able to generate domestically. The threat is that, in the end, with the government preempting so much of our available capital and credit, there won't be enough to go around to meet the needs of housing, of investment, and of consumers.

I observed a few minutes ago that, with nominal interest rates so far above observed inflation, a natural expectation should be for interest rates to fall. Part of the problem has been skepticism about whether progress against inflation can persist. And another major part has been the fact that Treasury financing works in the opposite direction -- toward keeping interest rates up. It does so both by the competition it creates 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

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deficits, that feed inflation. But I am afraid there is a strong instinct, an instinct reflecting a lot of experience around the world, that the two -- deficits and money creation -- often go hand-in-hand.

That need not be the case, and it's critically important that it not be the case now. We can keep money under control. What we cannot do is escape other implications of the deficit.

In the end, budget deficits -- like investment -- have to be financed out of the savings we generate as individuals and as businesses. But it is apparent there is not enough savings generated in the U. S. to finance both investment and a huge deficit. On a net basis -- that is, excluding depreciation allowances -- domestic savings for many years have been roughly between 6-1/2 and 8-1/2 percent of the GNP, and it is expected to run in the upper part of that range this year. But, with deficits, as now projected, remaining at over 5 percent of the GNP, not much would be left over to satisfy the needs of housing and business.

In this situation, we have been forced to increasingly look abroad for capital to supplement our domestic savings. Fortunately, for some time we have been able to draw upon foreign savings relatively easily. Funds have been attracted not just by our interest rates and by our strong stock market, but by relative confidence in our economic and political stability. Indeed, those inflows from abroad may total 2

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percent of the GNP or more this year, supplementing our domestic savings by about a quarter. The effect has been to blunt some of the impact of the budget deficit on our interest rates, and to help finance both the deficit and investment.

That's the good news. But there is another side. Reliance on increasing amounts of foreign capital is a tenuous and risky way to finance domestic growth and capital formation. For one thing, when we import capital, we also run a trade and current account deficit. Our trade deficit may well exceed $100 billion this year. That's why our exporters have not shared in the growing economy, and deficits of that size cannot be sustained indefinitely. Moreover, a steady and growing flow of foreign capital is dependent on confidence in our ability to properly manage our economic affairs, on relatively high interest rates, or both. To the extent our monetary or fiscal policies fail to justify that confidence -- to the extent inflationary pressures again appear to be ascendant or our external financial position is weakened by large foreign borrowings -- the greater the risk that new capital flows from abroad will come less freely. Then the consequences for the dollar, for interest rates, and for housing and domestic investment would be adverse.

The Treasury is going to get the funds it needs to cover the Federal deficit. The question is whether the private sectors of our economy will get enough funds, at

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reasonable interest rates, to support the balanced expansion, the investment and the productivity we want.

In essence, the demands of the Federal Government limit the rate of growth of other credit-absorbing sectors of the economy. The rationing device is interest rates held higher than would otherwise be the case. Under the circumstances, the more rapidly the economy grows and generates private credit demands, the greater the risk of rising interest rates. That's a situation we don't want to be in.

One clear possibility is that economic expansion will continue despite historically high interest rates relative to the inflation rate and financial strains -- after all, that same deficit that creates pressures in financial markets pours out a lot of consumer purchasing power. But it would be an unbalanced expansion, characterized by high consumption supported by large deficits, by relatively sluggish investment, and by a widening trade deficit. That, in itself, is hardly desirable in terms of the staying power of the expansion, in terms of the industrial capacity we need, and in terms of future growth and productivity. Some sectors, such as exporters, farmers, and homebuilders would feel the effects most strongly. But, in addition, we also must be conscious of the added risks strong financial pressures would pose -- to thrift and other financial institutions, to less developed countries with heavy debt burdens and their creditors in the

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U.S. and elsewhere, and to the fabric of international trade. At some unknown point the sustainability of the expansion itself would be jeopardized.

It's not a pleasant dilemma. Nor can we escape from the problem by "monetizing" the Treasury debt through excessive expansion of bank credit and the money supply. Of course, some might urge the Federal Reserve to take that approach. But the end result would simply be to inflate all the numbers. Money creation and inflation will not increase savings; in the end it would only aggravate the savings-investment imbalance by undermining confidence.

There is a clear and obvious answer to the dilemma. We can go to the source of the problem -- the excessive deficits. It is already too late to make significant changes in the budget outcome in this fiscal year 1984. But action now affecting fiscal 1985 and later years can only work in the direction of moderating potential pressures; if sufficiently forceful, the market could then well anticipate the time the actions become effective. At the least, the risks of eroding confidence and new market pressures should be relieved.

By now, this conceptual analysis is familiar and broadly accepted, in the halls of Congress and elsewhere. But none of us should underestimate the difficulty of converting an intellectual consensus into the hard political reality of action to reduce _specific_ spending programs or to change

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specific tax laws -- changes that affect people not in the abstract but directly. It is that process which is underway now. I cannot help but be encouraged by those efforts of so many in the Congress and in the Administration to produce a consensus on action. But I also sense that if these efforts are to come to fruition, there will need to be a clear sense of public support and acceptance.

Federal financial policies are my speciality, and they are of great importance. But they are far from the whole story. There is, for instance, the critical question as to whether the strong efforts in the private sector 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 during 1983 large collective bargaining agreements had first year wage settlements (excluding C.O.L.A.'s) averaging about 2-1/2 percent, the lowest since the data began to be collected in the mid-1960's. On the cost side, that's good news because wages and salaries, in the aggregate, account for about two-thirds of all costs.

As usual, when we look not back but forward, the evidence is more ambiguous. About half of the large new

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settlements, in industries where the recession did not bite so hard, ran to 6 percent or more, only moderately below the earlier trend. If generalized, settlements of that magnitude would place a rising floor under costs, and would be inconsistent with progress against inflation.

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 or outright controls. 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. As you know, 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 competitive pressure is exaggerated currently by the exceptional performance of the dollar, and there are dangers of a strong protectionist response. But I suspect 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

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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.

We cannot, of course, expect restraint on wages and other costs if we permit inflation to get the upper hand again. The lower trend of nominal wage increases over the past two years has, because of the drop in inflation, been consistent with higher real wages. That is what the economy is supposed to produce, and, so long as it does so, restraint on wage increases is justified.

In the end, those increases in real income will depend on efficiency and productivity, and all our public policies need to be conscious of that need. That is one reason the impact of the deficit on interest rates and investment is so important, and why we should welcome competition at home and from abroad.

But discipline and productivity will also have to be reflected in attitudes permeating a whole range of private decision-making approaches rooted in our own market system and political environment. To take one example, from my perspective I welcome the interest in profit-sharing arrangements or other ways of rewarding workers when things are good, without building in an inexorably rising floor on costs. Other initiatives to create more cooperative relationships between management and labor and to improve productivity --

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the concept of so-called quality circles used so widely in Japan, more flexibility in work rules combined with greater job security, and the like -- seem to me to carry promise for the future. Many of those initiatives, born in adversity, can serve us well in prosperity.

All of this is why I, for one, believe it is within our grasp to see the 1980's -- a decade begun in the slough of recession and uncertainty -- become a decade of growth and stability.

But I don't want to fall out of character and leave you on a note of undiluted optimism. After all, I am a central banker. Somebody once remarked to me that central bankers are like puritans. They have a haunting fear that someone, someplace may be happy.

We do have a great opportunity -- the best in more than a decade to put the economy right.

But we will also have to work at it -- and work hard -- to make that vision a reality. A lot of that work has to be done in Washington -- but in our democracy that will require public understanding and support. And as much will depend upon how we, individually, go about our business and our work all over the country.

I believe we have learned, from hard experience, that no real solution can be found simply by turning on the monetary valve and seeing inflation renewed.

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We need a monetary policy consistent with restoring stability. And other policies -- public and private -- must also be consistent with that purpose. Big deficits take too much of the available credit. Rigid labor or product markets, protectionism at home or abroad, failure to carry through on the gains in efficiency and productivity would all work against growth and stability.

We are all on the firing line. But we've come too far -- at too much expense -- to turn back now. And I am convinced we have the vision to see it through.

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