United States and the World Economy

This is my first opportunity since arriving at the New York Fed to give my views about the international situation. It is a special pleasure to do that for this knowledgeable audience. I recognize that many of you here this evening derive considerable professional benefit from having an unceasing stream of world problems to report on. Looking ahead, I can predict one thing with some certainty. There will be no shortages of raw materials for your industry.

We are confronted by the reality of intractable inflation, the certainty of massive payments deficits among oil-consuming countries, and the likelihood of economic contraction, or at best a prolonged slowing of economic growth. The key point to consider is that these problems are not simply cyclical in origin. They cannot be attacked adequately by traditional demand management policies developed over the short term. They are, in part, consequences of oil price and supply instabilities which are not going to go away and may grow still worse during the next five years. Since these problems are medium- or long-term in character, it will take not only imagination and skill to deal with them, but also determination and perseverance in a broad range of policy areas. Above all, we need the guts to propose, to debate, and to take unpopular actions whenever necessary—and certainly until a broad constituency for discipline and self-restraint is secure.

The economic outlook is pessimistic. But this does not mean the situation is hopeless. To the contrary, we are impelled to seek ways to bridge the gap between today's dilemmas and what might be a more hospitable future. The energy vise can be loosened by development of alternative energy sources and by decisive cutbacks in our energy consumption, even greater than we are now achieving. On both fronts, I expect us to remember the lessons we should have learned since the first oil shock and put them to good use.

I recognize there are those who differ, and who are not terribly worried about the outlook, or at least say they are not. They claim that the world came out of the first oil shock not too badly—that yes, there was a severe, synchronized recession, but we recovered from that. The banking system recycled surplus oil revenues reasonably well. The OPEC (Organization of Petroleum Exporting Countries) surplus declined fairly quickly because large amounts of imports were absorbed. After the initial price shock, the oil price, adjusted for general inflation—the real oil price—actually fell. All this could happen again, they say.

Some go even further. This time, they say, the initial conditions may be less troublesome. There are no big current account surpluses among industrial countries to compound the adjustment problem, as there were last time. The business cycle is less synchronized, and since we did not have a simultaneous boom (as in 1972-73) there is little risk of a simultaneous world recession. Finally, the recycling process itself could go more smoothly because many developing countries have built up sizable reserves and have been able to generate impressive export growth.

I would admit there is clearly something to each of these points. But, taken as a whole, the argument

Remarks of Anthony M Solomon, President of the Federal Reserve Bank of New York before the Reuters annual dinner on Wednesday, May 14, 1980 doesn't wash. It neglects the fact that there is an overriding difference between the first oil shock and the situation we are in now. There have been fundamental changes in the perceptions and policies of OPEC and its members. Because of those changes, I cannot foresee any early decline in the OPEC surplus or any meaningful reduction of real oil prices. If anything, real oil prices could go up further.

Bear in mind these four key factors:

First, OPEC import demands are not likely to expand anywhere near as fast, or as much, as they did before. Several countries have learned the practical limits to their absorptive capacity. They are unwilling to repeat past mistakes of taking on too many complicated projects all at once. The social implications of rapid development have been a source of concern to many countries, especially where large numbers of immigrant workers are involved. In addition, some countries have not been able to run profitably the expensive plants and technology they installed in the first flush of new oil wealth. And other special circumstances, such as the Iranian upheaval, have had direct and indirect consequences on import demand that will not quickly disappear.

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Second, OPEC's attitudes toward supplying oil have changed. The OPEC members have learned a great deal about how to create and perpetuate a tight supply and demand situation in the short term. A number of countries have made it known that they are prepared to hold back production if that helps force real oil prices higher. That threat is not an idle one, given recent levels of world demand.

Third, the more moderate OPEC members have come under criticism within their own countries for taking a relatively accommodative attitude, specifically toward oil pricing and production, and more broadly toward the United States and our interests. This atmosphere of criticism has tended to mute the voices in favor of moderation. And, as a result, the more strident elements within OPEC have strengthened their position. They will seek to use that preeminence to secure larger real revenues by keeping continual pressure on the oil market.

Finally, many OPEC members have been disappointed by the earnings they have made on financial assets. They claim those earnings were eroded by inflation and currency fluctuations, while had they kept the oil in the ground they would have done better. *Ex post*, that is a hard argument to contradict But I can envisage a different outcome in the future. Once convincing efforts, even if long run, are under way to develop alternative energy sources and to achieve drastic cuts in oil consumption, the immediate arithmetic can be radically changed. At that point, we can expect a major change in attitudes in favor of selling oil rather than leaving it in the ground.

But we are far from that point now. The clear, unavoidable conclusion is that the OPEC surplus is going to remain massive. Therefore, the rest of us will face an increasingly difficult struggle to sustain tolerable levels of trade and economic activity while combating inflationary pressures stemming from higher oil prices. If we cavalierly treat the second oil shock as self-adjusting and self-limiting, we risk incalculable long-term damage. We must prepare policies that offer the best chance of minimizing the economic damage—almost sure to be mounting year by year through the entire period of oil vulnerability. We cannot count on OPEC behavior to bail us out again. However, it is defeatist to conclude that the problems are too difficult to confront and that all we can do is ease the pain. We have the capacity to put together a workable program of collective actions to deal with these common problems. In general terms, the necessary ingredients of such a program can be readily identified

First, we must manage our domestic economy and our currency better. We must avoid the kind of stop-go policies that have tended to amplify the cyclical behavior of the economy. In particular, we must rid ourselves of an inflationary bias that comes from stops that are fairly short and from go periods that last too long.

A firm commitment to eliminate inflation, along with the biases that tend to sustain it, is essential. The United States was built on a foundation of mutual trust and consent. That foundation risks being eroded by prolonged inflation. It gnaws away at the financial assets that average citizens have painstakingly tried to build up for themselves and their families. In the process, inflation ridicules the saver and rewards the impatient. A country can go only so long pitting one group against another—which of course is the very essence of inflation—without tearing apart the fabric of social cohesion that underlies democracy.

Moreover, no country can, for very long, maintain its political influence around the world, maintain its military credibility, protect its vital interests abroad, or promote its ideals and principles if it must rely on inflation as an expedient to avoid resolving competing claims within its society. I wonder if we can seriously expect other countries to take us, our power, or our words seriously if we are incapable of self-restraint, discipline, and constructive compromise at home.

These considerations also feed back on the dollar in the exchange markets. I am convinced that the impact on a currency of differential inflation rates among countries is much more elemental and profound than many believe. To be sure, the economic dynamics are important Excessive inflation starts by undermining industrial competitiveness, then leads to deterioration in trade, and inevitably to exchange rate weakness, unless interest rates are high enough to pull in capital.

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But I would appeal to a broader perspective. The basic factor influencing the decision to buy or sell a currency is whether the country issuing it can be counted on to fulfill its end of the bargain. Chronic inflation undermines the source of confidence which, once lost or diluted, cannot easily be restored.

And so today we can no longer ignore international developments as we decide on the proper course of domestic monetary policy. We know from experience that a falling dollar compounds our inflation problems, worsens inflationary expectations, and further weakens our ability to get support from those OPEC members which are moderates toward oil price increases.

But now, a new factor has come into play. A recession in the United States entails a slowing in credit demands. Thus, there are fewer market pressures on interest rates. This already had led to sharp declines in short-term rates, and potentially could lead to further declines. The market knows that since last October 6 the Federal Reserve, in achieving its monetary targets, has put greater emphasis on tracking the reserve aggregates and less emphasis on maintaining interest rates at any particular level. The market knows this intellectually, but it seems to me there is still an instinctive tendency on the part of many traders to read Federal Reserve policy from the course of short-term interest rates, rather than from what is happening to money supply and credit creation.

This may be an unfortunate anachronism. Yet, it is imbedded in market behavior, and we cannot dismiss it as we seek to achieve reasonable stability for the dollar. Once appropriate monetary and credit targets are set, we cannot repel all market pressures toward lower interest rates. But we should ensure that rate declines are orderly and consistent with holding to our monetary targets over a longer time. Moreover, no one should forget that we have adequate means for preventing exchange market instability as this process develops. We have been, and are, prepared to use those means whenever appropriate

Experience shows that exchange markets eventually look beyond movements in short-term interest rates to the economic fundamentals—our balance-of-payments position and our inflation performance. Confidence will be achieved on a permanent basis only if we are able to convince the markets that we are determined to maintain monetary discipline judiciously over time. To do that, we must not move back and forth between unsustainable restriction and unsustainable ease. Stop-and-go policies must go

Second, from the international perspective, we must work to maintain tolerable levels of world trade and economic activity during the period of oil vulnerability. That means we must work cooperatively with other major countries and, within the context of the International Monetary Fund, to make sure that the pattern of deficits confronting protracted OPEC surpluses is fair and appropriate. The burden should not be allowed to fall excessively on any one country or group of countries. And no country should pursue policies designed to unload its deficits onto others A failure to harmonize our policies could gravely threaten the prospects for maintaining trade and growth.

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Right now, economic activity is still expanding in most countries abroad, although more slowly than last year. No signs of general recession have appeared. However, inflation rates have been rising virtually everywhere. Thus, a basic emphasis on monetary restraint continues to be reasonable In my view, it is the increase in inflation rates and the monetary response to that increase which accounts for most of the recent interest rate rise abroad. Only to a very minor degree is there an element of validity in the concern about so-called "interest rate wars" for competitive exchange rate appreciation.

But I believe it is of the upmost importance for the authorities to avoid any temptation, or even the appearance, of a competitive interest rate escalation. The exchange markets are nervous and volatile. It cannot be a contribution to stability to leave the impression that monetary policy is directed toward narrow parochial objectives and is indifferent to the need for cooperation and harmony. Indeed, since interest rates in the United States have declined markedly, it may now be timely for other countries to consider whether their current rate structure is still appropriate.

In its surveillance of the adjustment process, the IMF can play a special role to help prevent backsliding into "beggar-thy-neighbor" policies. We must all do our part to reject inward-looking policies on interest rates and exchange rates, as well as to resist protectionist forces. Otherwise, we risk permanent harm to the liberal trading environment that still forms the basis for expanding world trade and adequate economic growth If that basis is undermined, any hopes we have for reducing world inflation will evaporate. It is strong, healthy competition in the marketplace that provides the surest defense mechanism against the inflationary biases in each of our domestic economies.

Third, we must assure that there is adequate financing for the deficits caused by the oil shock. Both official and private sources of financing must be kept open. There is no reason why commercial banks should not continue to lend in sizable amounts, as long as they perceive that countries are managing their economies prudently and keeping deficits from getting unsustainably large. The best way of assuring that continued flow is for the IMF to be in a position to meet its responsibilities, providing balance-of-payments financing conditioned on countries pursuing agreed stabilization programs. To that end, the IMF must have sufficient resources to lend, and that depends on approval of proposed member quota increases. For us to do our part and to maintain our influence in the organization, the United States Congress should approve the legislation now pending to increase our quota.

The quota increase is a necessary first step. Other steps may be needed later to strengthen the IMF's role in the recycling process, either through new facilities or new operating procedures. For example, the IMF could supplement its own resources by borrowing directly from OPEC members to lend additional funds to countries pursuing stabilization programs.

But well before other options are considered, one thing seems essential. As oil surpluses mount, the OPEC members must respond by placing substantial and increasing amounts of money directly with developing countries, particularly the ones without ready access to private markets. OPEC cannot stand back from the economic and financial consequences of its oil-pricing decisions by simply investing through financial intermediaries.

I see no reason why these investments could not be structured so as to further the interests of individual OPEC members in having a diversified portfolio. Various types of instruments could be developed which would provide features not ordinarily obtainable in private financial markets Imagination and experimentation would be required. But that should be forthcoming once OPEC members have recognized that they bear responsibility for investing their surpluses more broadly, and that to do so is in their own interests.

Finally—and, from a long-term perspective, most importantly—we need to build on the useful first steps that have been taken to achieve a truly effective national energy policy. And our allies need to strengthen their own efforts as well. The only credible way of curing OPEC-caused deficits is to produce more energy domestically, and to conserve significantly more energy here and in all industrial countries.

Facing up to energy reality was an agonizingly slow process, but now the basic consensus in favor of price decontrol seems to be in place We have already seen results. Over the past year, the painful, but necessary, increase in domestic crude oil prices has amounted to almost 80 percent. As prices of final products have risen, total United States petroleum consumption has gone down by more than 10 percent, with industrial consumption dropping more than 15 percent. And this adjustment occurred even as the economy was still growing. The recession should induce further conservation efforts.

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But more must be done. I believe the United States should provide strong leadership in helping develop important new energy policies with our allies. The Venice Summit should provide an opportunity to make a start. We have to achieve substantial cutbacks in oil consumption. To do so will require controversial and painful measures. I have no illusions about the unpopularity of such steps, or the natural reluctance even to talk about them on the ground that they are politically not feasible. But we cannot close off discussion. And we cannot be dogmatic about what may or may not be politically feasible once a solid case is made and strong leadership is applied.

Our objectives should be to take out of OPEC's hands the ability to force real oil prices higher, to unblock OPEC restraints on oil production, and to retain in our country the money that would otherwise be paid as a tax to OPEC members in the form of higher oil prices. The approach we should be considering can justifiably be called "domestic recycling". Instead of paying increasing taxes to OPEC, which merely proves to them that we are addicted to their oil and will therefore pay even more heavily for it, we can pay taxes to ourselves and recycle the proceeds domestically—to support energy development, to encourage cost cutting in industry, and to remove deeply rooted inflationary biases from the economy.

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Domestic recycling can be done in different ways. The most obvious is through substantial excise taxes on gasoline. To set in motion rapid adjustment, we would have to announce a schedule of yearly increases in those taxes—so much per gallon this year, so much more the year after and the year after that. Simultaneously, we would have to structure the domestic recycling effort to neutralize most of the adverse impact on the overall inflation rate, and to assure that the burden of adjustment does not fall too heavily on the weakest in our society. Clearly, the task would be formidable.

But this kind of approach can work quickly. Higher prices of oil products induce lower consumption; the recent experience proves that the elasticities are there. Moreover, the approach gives us the leverage to assure that complementary conservation measures are adopted at the same time by our allies. Oil demand could then begin to drop sharply, hopefully beyond the amounts that OPEC is prepared to counter with production cutbacks. There is a good chance that the increasingly heavy production declines that would be required to keep the oil market from softening would seriously test the determination of the cartel. That is a prerequisite for shaking OPEC out of its present attitude that oil prices will do nothing but rise in the future.

Equally important is to generate concrete progress toward developing alternative energy sources. That may well take much longer to achieve than reducing consumption. But we must speed the process, and that makes it all the more imperative to pursue domestic recycling so that resources are available for this national effort.

Clearly, taxes on domestic oil use would add to measured inflation in the short run and the adjustment process will be difficult. But by retaining these tax revenues at home rather than paying them out to foreign producers we can best ease the harmful effects of rising real oil prices. The domestic recycling of these funds can provide several direct benefits to our economy To the extent they augment general Government revenue, these funds would permit tax cuts elsewhere and a less inflationary financing of existing Government programs. Some of the revenues could be directed to the weakest sectors of our economy and those most seriously affected by the higher oil price to ease the adjustment burden Also, tax revenues recycled into alternative energy source development or energy conserving investment would both ease the adjustment burden by generating new employment and more quickly reduce our dependence on foreign oil. Finally, domestic recycling, to the extent that it reduces the resource drain to OPEC, improves our balance of payments and relieves pressure, both direct and indirect, on the dollar.

I recognize that the domestic recycling approach initially would be painful. But the potential rewards are worth the pain. It is far better to act now than to acquiesce to continuously higher oil prices for the indefinite future. And it is far better—for the United States and for the world economy—to recycle the wealth of our citizens at home rather than to transfer that wealth to OPEC.

Some people fall back on cynicism when they look at the outlook. Either things will take care of themselves, or they will be so bad that nothing much can be done except to prescribe painkillers. I reject this reasoning. Loosening the OPEC vise will take time but can be done if we can adopt the decisive energy measures that are needed. Holding the world economy together in the meantime can also be done, and done fairly well, if we exercise discretion in our domestic policies and cooperation in an international framework. I will continue to work toward these goals, and I hope you will too.