

## MEMORANDUM FOR THE PRESIDENT

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Subject: Prospect and Policies for Inflation Over the  
Next Several Years

memo to  
President on  
Fed Funds?

During the past several months, a growing concern has developed around the country about the outlook for inflation. Your April 11 announcement of steps to implement the anti-inflation program was an important step in dealing with the inflation problem. Realistically, however, the chances are no better than 50-50 that the anti-inflation program will lead to a significant moderation of wage and price increases -- even if it is followed up vigorously and continuously.

A major question remains, therefore, as to the prospects for inflation and the appropriate course of public policy to deal with the longer-term inflationary problem.

The increased public concern about inflation appears to stem largely from the recent sharp increases in food prices and the deterioration in the 1978 food price outlook, and to a lesser extent from the expected price effects of the depreciation of the dollar in exchange markets. The worsening of inflation stemming from these sources is likely to be transitory and of much smaller proportions than the effects of special factors that drove up the inflation rate in 1973 and 1974.

As yet, it is not certain that a significant acceleration of the underlying rate of inflation has occurred -- although, as indicated below, some disturbing signs have emerged. Nevertheless, there are compelling reasons for giving substantially greater priority to controlling inflation in economic policy decisions:

- o The underlying rate of price increase has clearly not decelerated. The 6 to 6-1/2 percent rate prevailing since mid-1975 is unacceptable economically and is politically damaging. The American people are deeply concerned about the current inflation problem.
- o The unemployment has declined from about 7-1/2 percent a year ago to about 6-1/4 percent presently -- more improvement than we had expected. A further reduction, to the neighborhood of 5-1/2 - 5-3/4 percent, is likely to occur over the next two years if our forecast of real GNP growth is realized. As unemployment declines, it makes good sense to give increasing weight to control of inflation.
- o As slack in labor and product markets decreases with a rising level of economic activity, the balance of risks increasingly shifts toward greater danger of acceleration. A dramatic acceleration of inflation

appears unlikely, but preventing a moderate, but steady, rise in the inflation rate will require constant vigilance and great care in the formulation of budgetary and other economic policies.

- o A significant increase in the underlying inflation rate from present levels would have very serious economic and political consequences.
  - Pressures in financial markets would intensify greatly, and economic growth would slow.
  - Achievement of our basic economic goals would be set back a number of years.
  - A recession at the time of the 1980 election, together with an inflation rate considerably higher than at present, cannot be ruled out.
  - The dollar could continue to decline in foreign exchange markets, aggravating the inflation further and creating serious tensions between the U.S. and our trading partners.

The time has therefore come to reexamine our long-term macroeconomic policy strategy and to consider whether, and to what degree, changes are needed to come to grips with inflation.

The Administration's Long-Term Program for Dealing with Inflation

As background, it may be helpful to sketch the broad outlines of our overall strategy for dealing with inflation, and to consider what we know at the moment about the success of that strategy.

A year ago, we set for ourselves ambitious economic goals and embarked on a course of policy to realize them. We have always recognized that achievement of a 4-3/4 to 5 percent unemployment rate by 1981 carried a potential threat to inflation. Our budgetary strategy was designed to move us gradually toward those goals, with the hope that a new round of inflation would not be touched off. However, we have always recognized the possibility that inflation could begin to creep up before those rates of resource utilization were reached. The point at which wage and price increases begin to accelerate in response to

reduced slack in labor and product markets remains an unresolved issue.

Our policy strategy for dealing with the threat of inflation has three principal elements:

1. A program to unwind from the 6 to 6-1/2 percent underlying rate of inflation that we inherited from the past. The April 1977 anti-inflation program was designed to accomplish this objective, as was the deceleration program announced this past January.
2. Efforts to reduce the potential for price shocks and to minimize the direct contribution of government actions to increases in costs and prices.
3. Measures, such as jobs and training programs, to provide work opportunities for the disadvantaged. In the process, we hope to decrease the rate of unemployment at which wage rates begin to accelerate.

VP [ Steps taken to implement the April 1977 anti-inflation program were not vigorous, and the underlying rate of inflation did not decelerate.

Our efforts to reduce the governments' own direct contribution to raising costs or prices, and to reducing the potential for exogenous price shocks, has also been relatively unsuccessful. In a few areas, we have made progress. Airline fares have come down; farmer-held grain reserves are being built up, and safety and health regulations promulgated by OSHA have been reduced in number. But increases in payroll taxes are adding materially to business costs, as is the rise in the minimum wage, and protection from foreign competition

has been extended to a number of industries. Actions that we took, or to which we acquiesced, in these areas may have been difficult to avoid. But we have not made the progress we had hoped for.

The various jobs and training programs we have introduced as a means of reducing the rate of unemployment at which pressures on wage rates begin to develop may succeed. Several of the important new programs -- the \$400 million private sector initiative in the FY 1979 budget, the jobs program in welfare reform, "soft" public works and the employment tax credit in the urban policy proposal, have yet to get underway. There is no doubt that these programs will add to employment and increase job opportunities for the structurally unemployed. But whether they do so in ways that reduce unemployment among minorities and teenagers without putting upward pressure on wage rates is still an open question. We will not know for a couple of years whether, or to what degree, we have been successful.

#### Recent Price and Wage Developments

In light of the lack of progress on the inflation front to date, the outlook for inflation at the present time is worse than had been expected. The principal factors that have led to larger prices in recent months (the runup of meat prices and the effects of the depreciation of the dollar)

are not the principal worry. Their effects on the inflation rate will be confined largely to 1978. There could be some spillover effect on wages and prices in 1979, but those effects would be manageable. The main source of concern is that wage rate and cost increases may already be moving up because of competitive bidding for labor.

The best single measure of wage rates is the index of average hourly earnings in the nonfarm business sector. That index adjusts for changes in the mix of employment between high and low wage industries and for changes in overtime in manufacturing. Increases in average hourly earnings (see table) decelerated in 1975 and 1976 and then stayed relatively constant at 7 to 7-1/4 percent through the first 3 quarters of 1977. The year-over-year increase moved up to 7-3/4 percent in the fourth quarter of last year and to 8 percent in the first quarter of this year.

Percent Increase in the Index of Average Hourly Earnings  
(change from a year earlier)

1975	Q1	9.7
	Q2	9.1
	Q3	8.6
	Q4	8.2
1976	Q1	7.7
	Q2	7.5
	Q3	7.2
	Q4	6.8
1977	Q1	7.1
	Q2	7.1
	Q3	7.3
	Q4	7.7
1978	Q1	8.0

There are two special factors that could account for most or all of the wage rate acceleration in 1977:

- (1) The rise in the overall CPI moderated substantially in 1976, due to stability of food prices, and then accelerated last year as food prices rose sharply. Because of cost-of-living adjustment clauses in labor contracts, and informal arrangements some employers have to relate wage rate increases to movements in the CPI, this pattern of consumer price changes would be mirrored in wage rate behavior.
- (2) The January 1, 1978 increase in the minimum wage may have affected wage changes in the private sector late in 1977. Some employers anticipate changes in the minimum wage so that they get the credit for increasing their employees' wages.

*See Soc. Sec. Act?*

If these two factors explained all of the acceleration in wage rates during 1977, some deceleration in wage increases might occur this year. Unfortunately, we cannot be sure that this is the case. There is a possibility that labor markets have already tightened enough -- even though the overall unemployment rate is still above 6 percent -- so that wage rates are now coming under pressure from competitive bidding by employers for workers with better skills and training. In that event, a further decline in unemployment would lend to a continued creeping up of the increase in wages, costs and prices.



## The Outlook for Inflation

The outlook for inflation thus hinges importantly on the interpretation of recent wage rate developments and what they mean for the underlying rate of inflation. Our best judgment is that unless the deceleration program is successful, increases in wage rates are likely to continue moving up over the next several years if our goals for economic growth and reduced unemployment are realized.

Based on past history, wage acceleration is likely to be a slow and gradual process. Wage rates and unit labor costs -- and hence the underlying inflation rate -- might move up at something like 1/4 to 1/2 percent per year. At the present time, the underlying inflation rate appears to be at the upper end of a 6 to 6-1/2 percent range, and it could be higher. Upward movement at 1/4 percent a year would put the underlying rate in the 7 percent range by the end of 1979 and the 7-1/4 percent range by the end of 1980. A 1/2 percent increase per year would mean a 7-1/2 percent rate by the end of 1979 and 8 percent by the end of 1980. A 7 to 8 percent range for the underlying rate of inflation during 1980 is thus a reasonable expectation if the anti-inflation program is unsuccessful.

Wage and price developments could turn out better than this if projections of some large econometric models are correct. For example, Data Resources Incorporated, one of the most well known econometric forecasting services, is presently

forecasting an inflation rate in the 6 to 6-1/2 percent range through 1980; the Wharton forecasting service expects a gradual rise to about a 7 percent inflation rate by 1980.

There is also a risk, however, that inflation may heat up more than our best-guess estimate:

- o If the wage settlement in coal becomes a pattern for the teamsters and other large contracts expiring in 1979, wage rate increases could accelerate sharply.
- o If the dollar continues to decline in exchange markets, there could be continuing pressures from this source on the domestic price level in 1979.
- o Unexpected developments in food prices or oil prices could aggravate the underlying inflation rate. Such developments are much more likely to add to price pressures than to relieve them.

If the worst happened on all fronts, we could see the inflation rate in 1980 pushing up well above 8 percent. This is not our best-guess estimate, but we cannot rule out the possibility of such a development.

#### Implications of a Heating Up of Inflation

Any significant acceleration of the underlying rate of inflation will have adverse consequences on real economic growth. Financial markets will begin to tighten as a result of increasing credit demands and expectations of rising interest

*Relevant  
new cycles.*

rates. Housing starts would be adversely affected, and the prospects for a strengthening of business investment would also be reduced. These tendencies would be accentuated by efforts of the Federal Reserve to hold the growth of the monetary aggregates within their target ranges. Over the past year, growth of M1 (demand deposits and currency) has been well above the Fed's long-run target range. The Fed would be unlikely to permit continuation of monetary growth overruns if the underlying rate of inflation began to rise significantly.

The adverse effects on real growth of tightening financial markets would be compounded by the effects of a rising inflation rate on consumer and business confidence and spending propensities. The personal saving rate would probably rise, and businesses would begin to pull back from commitments to long-term investment projects. A growth recession -- with real GNP still growing, but not fast enough to prevent a rise in the unemployment rate -- would be a high probability. If the worsening of inflation were severe, an actual downturn in real GNP would be likely.

A substantial rise in the interest rates may get started during the next few months, as economic activity rebounds from the effects of the cold weather and the coal strike. This early a

tightening of financial markets would produce its principal effects on real GNP growth in the first half of 1979. By early 1980, an improvement in the rate of real growth could be underway.

If tightening in financial markets began later, the adverse effects on real growth could persist into 1980. If the heating up of inflation and the resulting rise of interest rates were severe, we could find ourselves in the middle of a recession during the 1980 election campaign.

Even if this stark outcome is avoided -- and there is a good chance that it can be -- a worsening of inflation will clearly have serious consequences for the 1980 election. The American public is deeply concerned about inflation and what the government is doing to deal with it.

#### Implications for Public Policy

The grim prospects that we face if inflation heats up underscore the critical importance of following up our anti-inflation program vigorously. Unless we do so, some acceleration in the rate of inflation as we move toward a high-employment economy is a certainty. The only questions are when the acceleration will occur and how severe it will be.

The other major policy issue we must face squarely is the need for changes in budgetary policy. During the first year of your Presidency, our economic strategy

gave higher priority to reducing unemployment than to controlling inflation. In light of the condition of the economy when you took office, with the unemployment rate still at nearly 8 percent, that emphasis was correct. Since then, however, we have made substantial progress in reducing unemployment -- more than we expected -- but none at all in reducing inflation. The time has therefore come for a changed emphasis in budgetary policy.

We do not believe that a major shift in fiscal policy is called for. Slamming on the fiscal brakes will not solve the inflation problem, and it would produce disastrous results. But we must begin now to lean in the direction of erring on the side of too little, rather than too much, fiscal stimulus.

In terms of the fiscal 1979 budget, we see no reason for basic revisions of planned expenditures or of the magnitude of net tax reduction. But it is essential to keep the degree of fiscal stimulus in 1979 from exceeding the amount planned. You will have to be prepared to carry out your threat of a veto of appropriations or tax bills that would enlarge the deficit. And if a shortfall in Federal expenditures develops that permits budget outlays to fall below the \$500 billion mark, that shortfall should be welcomed as an opportunity to reduce the deficit -- not as an opportunity for new initiatives, or as a buffer that makes it unnecessary to resist Congressional add-ons to the budget.

What is the PT of this  
Memo. Can we even Balance the  
budget? (5+4, 1st '1)?

It is also extremely important, as you head into the fiscal 1980 budget planning cycle, to guard against commitments that have even the appearance of fiscal laxity. For example, some time in the next month or so, you are scheduled to announce your program of national health insurance. If that announcement implies large increases in Federal budget expenditures in the next few fiscal years, your April 11 statement on the budget will no longer have any credibility.

Greater emphasis on fighting inflation must also influence a variety of other decisions on economic policy. For example, you cannot afford to back down on your expressed willingness to veto any farm bill going beyond your recommendations, and you must strongly resist further extension of protection to industries adversely affected by foreign trade.

If the Administration's intentions to give greater emphasis to fighting inflation are to be effective, all of your advisers must be made fully aware of your intentions, and they must support them, publicly and privately. We will not succeed unless we have a united effort.



This is an anti-climax.  
We scare the shit out of him then  
say don't do anything. That is  
absurd.