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Remarks by

Henry C. Wallich
Member, Board of Governors of the Federal Reserve System

to the

National Economists Club

at the

Washington Hilton Hotel
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It is a pleasure to be invited to speak on "New Ways of Combating Inflation." It is the topic of the hour, of the year -- I hope not of the decade. As professional economists, you are aware, of course, that the title of my talk demands a near-impossibility. I know of no completely new ways of combating inflation, although I know of one or two that have not yet been tried. But there is something new about the situation in which we find ourselves that gives reason to hope that some of the old and familiar ways can be used to better effect.

One thing that is new, if you admit a perspective of some 20 years, is our contemporary analysis of inflation. During the 1950's, much of the analysis proceeded in terms of demand-pull and cost-push. One then frequently heard the argument that fiscal and monetary restraint could serve only in a demand-pull inflation. In a cost-push inflation, as which the price experience of the late 1950's was increasingly interpreted, policies directed against excess demand were said to be out of place. Nevertheless, these policies did bring back reasonable price stability and laid the groundwork for years of inflation-free prosperity.

Subsequently, Phillips Curve analysis came into vogue and blurred the distinction of cost-push and demand-pull. It was then argued that it would be a mistake to choose one's point on the Phillips Curve at too low a rate of inflation, and that firm fiscal and monetary restraints were therefore out of place. Structural policies designed to lower the Phillips Curve came into vogue. But the empirical evidence pointing to increasingly steeper Phillips Curves as successive years of new inflationary data were added to the earlier vintages, together with the accelerationist challenge, raised increasing questions about this approach.

More recently still, we have been exposed to yet a new form of analysis, based on the experience of the last couple of years, which focuses upon supply factors. Capacity shortages, bad crops, coincidence of cyclical peaks in different countries, and finally the OPEC cartel has provided the ingredients. Once more the conclusion that I hear drawn from the supply-oriented analysis is that fiscal and monetary restraints are inappropriate. But my impression is that this newest version of the old conclusion is less firmly believed and less widely supported than its predecessors. The reason for this is, I believe, not a change in the analysis itself, but a change in the evaluation of inflation, brought about by the acceleration of price increases.

The typical view that inflation is a zero-sum game while unemployment is not, while it continues to be literally true, has become increasingly irrelevant. Inflation gains and losses for income receivers and for borrowers and lenders still wash out. But the distributional inequities are less easy to ignore when inflation proceeds at a two-digit rate. People are making clear that, whatever economists may think of inflation, they dislike it very much.

The track records that the American and other economists now are making also seem to destroy the hope that the uncertainty of future inflation, and therefore its real cost, might be no higher at high rates than at low rates. I have never shared this hope, partly because I have observed the instability of inflation in developing countries which the industrial countries are increasingly coming to resemble. In part I have been skeptical of it also because the essence of the successful trade-off of lower unemployment against higher inflation seems to be the presence of money illusion, i.e., an underestimation of future inflation.

In European countries, meanwhile, high rates of inflation are increasingly seen as a threat to political stability. This threat is hard to evaluate. If democracy should go by the board in still another country, no doubt the evidence would be regarded as somewhat inconclusive. But it is significant that ideas of this kind now get a hearing. They would not have received it a few years ago.

I now turn to the main topic of my remarks -- methods for combating inflation. To begin with, let me refer briefly to some methods that I do not recommend. One of these is wage and price controls. I must confess that I have changed my mind about them more than once, and I hope I shall not have to do it again. When they were first introduced in 1971, controls did seem to have something to offer. The rationale of breaking inflationary expectations seemed convincing. The presence of much unused capacity seemed to forestall the dangers of distortion of supply and demand. Since then, things have changed drastically. It may be that these changes, principally the shift to an excess demand economy, have created a somewhat unfairly negative picture of what controls can do. But one is almost bound to conclude that controls can work, if at all, only in an environment of excess capacity in which inflation would probably come down even without controls.

Indexing is another nonstarter, in my view. I am referring to indexing as a means of halting inflation, which seems to be the sophisticated and, in my view, implausible way of looking at indexing. The popular view, on the other hand, that indexing is a form of living with rather than ending inflation seems to me only too plausible. But I would expect life with indexed inflation to be even more disagreeable and fraught with risks than life with its unindexed counterpart.

The sophisticated view says that wage increases should be set at a level that, after deducting the inflation escalator, would make them smaller than productivity gains. In that case, fully indexed wage increases would allow the rate of inflation to slow. As it slows, down comes the index and with it nominal wage increases. No strong restraint on aggregate demand would be needed.

So far the theory. But what happens if wage increases, after deducting the escalator, still exceed productivity gains? This, after all, has been the situation we have usually observed. In that case, prices, the index, and wage increases all go up, in perfect harmony and presumably with gathering speed. Some observers argue that this will not happen because some variables cannot be indexed, such as profits and money. Thus for a while wage increases could exceed productivity gains without causing the index to move at an explosive rate. But this view does no more than to highlight the problem. Indexing produces a naked confrontation over income shares, which otherwise would be decently concealed and thus resolved by inflation. This, it seems to me, is the more plausible model of the indexed economy.

The "social contract" theory is another inflation-fighting device that seems to have more logic than feasibility. Briefly, the idea is that labor would agree to restrain its wage demands in return for a reduction in its tax burden. The underlying theory seems to be that an adjustment to the higher price of food, oil, and other commodities, which represents an unavoidable loss of real income, can be made at two levels. One is the primary distribution of the national income between labor and other claimants. The other is the process of redistribution undertaken through the tax system. It is a mistake, so it is argued, to compensate labor for higher prices by a commensurate increase in wages, because the real income just isn't there. Wages and productivity would be thrown out of alignment by such an attempt. Instead, the damage inflicted by the weather, OPEC, and the business cycle should be reallocated by the redistributive tax mechanism. As a practical matter, unfortunately, I see no way of effecting a binding social contract with labor even assuming labor to be disposed to do so.

Since I am pouring cold water on somebody else's brain-child, I beg your leave to stand one of mine under the same shower.

The proposal for a surtax on corporate income triggered by excess wage increases has received a fair amount of discussion. Since it allows the market mechanism to work, it is not subject to the criticism that applies to other forms of control. It has two serious difficulties, however. One of them is that of administration, although this may have been eased by the experience of the Cost of Living Council in pricing out wage increases. The other defect, much more serious, is that business thinks the tax would be anti-business while labor thinks it would be anti-labor. I conclude that it is probably quite evenhanded. Politically, however, the proposal is unlikely to prosper unless the participating parties should switch their views.

A wide range of measures to combat inflation can be listed that have nothing to do with fiscal or monetary policy or with controls of any sort. These are the measures designed to improve the functioning of the market economy to make it more flexible, more mobile, more competitive, and more productive. Action toward those ends would be rewarding in itself, as well as helpful against inflation. But since these things have been discussed many times, and since my assignment is new weapons against inflation, this summary reference will have to suffice.

Some new developments, however, can be reported. They relate to measures designed to give monetary and fiscal policy greater freedom to do their number-one job, which is to regulate aggregate demand. These measures seek to free aggregate demand policy from the constraints imposed by its repercussions in particular sectors of the economy.

One such action applies to the housing market. The highly cyclical character of housing and its great responsiveness to the impact of monetary policy is traceable in part to the postponable nature of demand. In part, however, it can also be traced back to the structural characteristics of our housing finance institutions, which are vulnerable to disintermediation. Today, means are being developed increasingly, through government or government-sponsored agencies, to help tide over the home finance industry during periods when their normal flow of funds is sharply curtailed.

Something analogous is happening in the labor market. The government has been moving toward the use of public service jobs as a means of coping with unemployment. Ideally, these jobs should seek to enlist especially those age, sex, and occupational groups in the labor force that are particularly hard hit by unemployment. I need only remind you that a 5 per cent unemployment rate typically is an average of about 2.5 per cent for married males and about 30 per cent for black teenagers. We have increasingly come to realize that there are structural forces at work here to which the management of aggregate demand is not the answer. Monetary and fiscal policy can operate more effectively if problems in the employment sector, which often are only very indirectly related to fiscal and monetary policy, are dealt with by more direct means.

Even with a flexible fiscal and monetary policy, I am far from believing that we can finetune the economy. Nevertheless, it is necessary to recognize that up till now at least we seem to have been moving farther away from the old world of widely swinging business cycles and into the world of growth cycles which in terms of output and employment is less unstable. This progress may have been accomplished, to be sure, at the expense of moving toward higher rates of inflation. That precisely is the problem with which we now have to deal. The prevalence of growth cycle conditions implies that deviations from the normal growth trend of the economy most of the time should be small. Instead of rising unsustainably or actually falling, the economy has managed to stay somewhat closer to its growth trend. This suggests that inflation can be attacked by aiming at a rate of economic expansion that allows positive growth and increases in living standards but for a while at least nevertheless reduces pressure on capacity.

Development of better information on what we are doing and on what is actually happening represents another front in the evolving struggle with inflation. In the public sector this improvement in information, and therefore hopefully in control, is taking the form of a Congressional effort to coordinate particular appropriations by subjecting them to an aggregate ceiling. In the private sector, accountants are beginning, in my view much too slowly, to think about means of correcting or at least clarifying the impact of inflation on the affairs of business.

One such technique now under discussion is general price level accounting, which seeks to restate business accounts in terms of a constant dollar. National income accountants, of course, have been doing this for many years. A recasting of corporate statements in price-corrected form would not alter any real variables -- the prices businesses charge, the wages and taxes they pay, the profits they make. But the technique would reveal to businessmen what national income accountants have known all along, that corporate profits are far less than they seem. The impact of inflation on corporate affairs is more complex than its impact on those of the consumer. As a result, businessmen are in greater danger than others of falling prey to money illusion.

Our existing tax and accounting rules, moreover, offer business an opportunity to counteract the effects of inflation. Inventory profits can be largely eliminated by the LIFO (last in first out) accounting method, even though LIFO presents no permanent solution. Underdepreciation, the result of a mandated original cost base, can in some cases be overcome or mitigated by going to more highly accelerated depreciation methods. These procedures may make profits look pretty sick. But in an age of high-powered security analysis the stock market presumably reaches through the accounting veil to the facts as they are in any event.

Last of all I come to monetary policy. Here, too, there are some new developments to report. One bears on the relative usefulness of money supply and interest rates as guides to central bank policy. In my personal judgment, experience to date does not contradict the view that in conditions of inflation the monetary aggregates are a somewhat less uncertain guide than are interest rates. Nevertheless, the central bank should remain flexible in this regard. The fact is that inflation blurs the significance of either guide. Experience seems to validate the view that pursuit of a monetary aggregate target may cause greater instability in interest rates. But under a money supply or similar target, it is certainly a mistake to say that the central bank at any time is "pushing up interest rates." Interest rates go up during inflation, and they may rise temporarily as a result of adherence to a money supply target that seeks to moderate inflation. But a more expansionary policy that might temporarily ease market pressures can in the end lead only to more inflation and higher interest rates. The way to bring interest rates down is to bring down the rate of inflation. That can be done only with less monetary growth, not with more.

I would like to end with a generalization which I believe is plausible but which I cannot document in detail. The approach of monetary policy, almost by its nature, must be gradual. Severe restriction, even if temporarily effective, would almost certainly be counterproductive in the end. A gradual approach, however, takes time. That time ought to be available, so long as the economy remains in an uptrend, even though the uptrend is not very rapid. It was impatience with the slowness of results that frustrated the effort to end inflation during the previous expansion. If we can stay on a steadier course this time, I believe our prospects will be a great deal better.