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Remarks by

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

at the meeting of

The American Bankers Association

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The American Bankers Association has made a good decision in selecting its topic for today. Whatever disagreements may exist about inflation, there seems to be a consensus that it is the problem uppermost today in the minds of Americans. My function here is to lay out the nature of the inflation problem -- its causes and its consequences. Others will discuss what can and should be done about it.

The Causes

The main thing to be said about the causes of inflation is that they are manyfold and complex. We would be fooling ourselves by assuming that there is a single cause which could be dealt with by some simple solution. What I propose to do here, therefore, is to examine some of these sources in order to convey a sense of the complexity of the problem and to guard against a futile search for simple solutions. I shall not try to attach particular weights to individual causes.

Inflation, it seems to me, can be traced back to three different kinds of sources. The most fundamental of them are the preferences that our community has formed and that seem to deviate from those of the past in important respects. The second group relates to certain structural changes that have occurred in the economy. Ours is not the economy of the 1920's, or even that of the 1950's. These changes tend to make the maintenance of price stability more difficult. The third group of causes of inflation is related to our economic policies. Policies with respect to money, to interest rates, to government spending and taxing among others play an important role. It is important to recognize, however, that these policies are being pursued in the light of our changing preferences and of the changing structure of the economy. It is useless to complain about inflationary policies without examining their origins in changing preferences and changing structure.

Changing Preferences

To the extent that people consciously or unconsciously choose between the risk of recession and the risk of inflation, in recent years they seem to have been leaning in the direction of accepting a higher risk of inflation. In the past, recession was accepted as more or less unavoidable from time to time. Today we know that serious recession can be avoided, although at the risk of more inflation. The number of people who are hurt by inflation is probably much larger than the number of people who stand in fear of unemployment. But most people who are hurt by inflation are hurt only moderately. Many people hit by unemployment are hit severely, both economically and emotionally. Even the fear of unemployment has at least an emotional cost.

This reaction to the alternative risks of inflation and of unemployment might change in time as the rate of inflation becomes more severe while the personal tragedy of unemployment is tempered by better unemployment compensation, availability of public service jobs, manpower training, and higher income levels that make short-term unemployment more akin to job search than to distress. Even then, however, the loss of output for the national economy is likely to weight the economist's choice in favor of inflation and against unemployment.

An escalation of expectations, a belief that almost all conceivable improvements are almost immediately within our reach, seems to represent another well defined alteration of national preferences. The word "unacceptable" comes up with increasing frequency as a description of conditions that have prevailed since time immemorial but are now to be brought to an immediate halt. At the level of government, this attitude leads to deficits. At the level of households, it leads to a low savings rate and high borrowing.

Some of our changing attitudes seem to imply a shortening of time horizon, a growing preference for the short run over the long. The experiences associated with inflation typically are pleasurable in the short run, painful in the long. The costs of fighting inflation, on the other hand, are immediate, the benefits from a successful struggle come only over the years. For governments and politicians who must necessarily think in terms of short time spans if they mean to survive, this attitude is not irrational. For the people as a whole, the long-run cost of short-run actions often is difficult to evaluate. The economist's job should be to inform people about this trade-off and to lean, if lean they must, against the wind of short-run preferences.

Perhaps one could summarize our changes in attitudes with regard to inflation by saying that we have been very ready to escalate the rate of price increases that we are willing to accept. The attitude of the financier, oriented in good part toward price stability, has been displaced by that of the economist or production man, who is employment oriented. Successive statements of public figures about what might constitute acceptable rates of inflation have moved from the range of 1-2 per cent to levels that not many years ago would have been altogether unacceptable.

Structural Changes

It is a commonplace that prices and wages have become more rigid, and in particular that wages have become altogether inflexible downwards. Rising prices of particular goods are less likely to be compensated by other prices that fall. The same must be said with regard to periods of rising prices. But it would be an exaggeration to say that prices have become altogether inflexible downwards. Prices of many manufactured goods have in fact trended down for prolonged periods. The evidence also says, however, that prices are closely tied to costs, the principal of them usually being wages. Thus with costs rising, the price flexibility that still exists manifests itself less frequently.

The growing imbalance in the relative power of labor and management is another structural factor. Management seems to be increasingly doubtful that it can win major strikes. Unions seem increasingly confident of their strength. Political factors, the economic damage from major strikes, unemployment compensation for strikers in some states, the expectation of both management and labor that the effect of high wage increases will be compensated by expansive public policies, all favor strong demands by labor and their acceptance by management.

The changing structure of the labor force is another familiar fact. There are more women and teenagers, who are less firmly attached to the labor force than heads of households, and who usually are not the principal breadwinners. They raise the average unemployment rate. They likewise make idle labor capacity appear greater than it may be. A 2.5 per cent rate of unemployment among married males, only about one-half of which with a duration in excess of five weeks, may constitute substantial tightness at the core of the labor market. Yet such numbers today are associated with an over-all unemployment rate of about 5 per cent when years ago it used to be associated with one of closer to 4 per cent. The present unemployment rate of about 15 per cent among white teenagers and about 30 per cent among black teenagers is a national calamity and demands urgent action. But averaging it with the 2.5 per cent married males or the 3.0 per cent heads of households who are unemployed leads to policy conclusions that do not help teenagers very much and can be very harmful to the economy.

Average unemployment has been pushed up by demographic developments. Meanwhile the sensitivity of organized labor to the unemployment statistics seems to have diminished, a development that in some respects has been a constructive feature of the American labor movement. It has made labor more willing to accept advances in technology that have raised productivity. But low sensitivity to unemployment of course is not conducive to restraint in wage bargaining. As we make progress in raising labor income and improving unemployment compensation, we are likely also to insulate labor further against the employment consequences of its wage demands.

Greater awareness of inflation is itself a cause of further inflation. On the part of labor and business, this growing awareness already is finding expression in more comprehensive escalator clauses. On the part of lenders and borrowers, it leads to interest rates demanded and paid that reflect the lender's fear of losing purchasing power and the borrowers hope that inflation will convert nominally high into really low rates.

Supply shortages are another structural factor that recently has contributed to inflation. Skyrocketing food prices have reflected in part bad harvests, but they have also brought to light our underlying capacity limitations. Oil is a special case, but the shortage of many other raw materials has revealed insufficient capacity, as well as business cycle and speculative influences. Shortages of industrial materials, finally, very clearly reflect inadequate past investment in productive capacity. We have allowed the structure of production to narrow at its base. More investment in productive facilities is needed, which in turn require stronger incentives and a bigger cash flow.

Policies

I have devoted some time to the changes in preferences and in structure that underlie the inflationary process in order to show that to put the blame for inflation on government policy is an oversimplification. We are told persuasively that if the government were to hold down spending and balance the budget, if the money supply would grow at a noninflationary rate, inflation would come to an end. Very likely it would. But there are reasons why, given the preferences and the structure of our economy, such policies are difficult to pursue. Government policy is not made in an economic and social vacuum.

This is very obvious particularly with respect to budgetary policy. The desire to do too much at once, the unwillingness to accept occasional slack in the use of human and material capacity are very clearly reflected in the budget process. With respect to monetary policy, the case is less simple. We are told by some that monetary policy is the sole cause of inflation because there has never been an inflation without an excessive increase in the money supply. If no more than the proper amount of money were placed in circulation, there would be no inflation. This is just as true as the statement that life could be preserved by maintaining a proper blood circulation, because no case of death has ever been observed while the body's blood circulation continued. The problem is that at times there are impediments to maintaining either the proper circulation of blood or of money. But to ignore what causes the excess or deficiency is something that doctors would not do and economists should not do either.

The real causes of inflation lie deeper than monetary factors. They nonetheless are not unalterable. The present widespread concern about inflation gives hope that people will indeed demand changes in economic structure and policy that will bring down inflation. I believe that this is coming to be the popular mood because of the very serious consequences that inflation is now seen to have. To an examination of these consequences I shall now turn.

Consequences of Inflation

Inflation affects both the real and the financial sector of the economy. Economists tend to think of the real sector as being decisive for welfare, with finance as only a handmaiden. I shall therefore begin with some observations on what inflation seems to be doing to output, employment, and the distribution of income. But the effects of inflation on the financial sector, which should be of particular interest to this audience, have mounted to a level where they are bound to have major effects also on the "real" variables that are the favorite diet of the economists.

Prevailing doctrine has had it that inflation is favorable to employment and output, on the grounds that unemployment can be reduced if some inflation is tolerated. This view, I believe, is being increasingly exploded by events. It rests on the assumption that one can fool all the people all the time, i.e., that people do not notice inflation, therefore do not guard against it, and that consequently a given rate of inflation will produce constant benefits in terms of employment and output. Experience shows that people are very much aware of inflation, that they try to protect themselves by demanding higher wage increases and to some extent higher interest rates, and that the employment and output benefits of a given rate of inflation therefore are rapidly eroded. Thus inflation tends to accelerate.

Nobody denies that inflation has severe consequences for distribution of income and of wealth. We have no way of quantifying these effects. But at present rates of inflation it seems obvious that people lose substantially if their incomes are relatively fixed or if their savings are predominantly in monetary assets. Such losses may be large compared to the income loss of households encountering unemployment of the average duration of about two months, although we must not forget the heavy psychic cost of unemployment. On average, of course, gains and losses from inflation, in terms of above and below average income increases and in terms of net debtor or creditor positions, wash out. That, however, is also hardly a reason to ignore them.

Inflation affects not only the total utilization and the distribution of resources, but also their allocation. The most obvious example is what is happening to housing. This impact, of course, takes effect via the damage inflation is doing in the financial sector.

Finally, inflation reduces wellbeing by generating new risks that do not exist when prices are stable. In an inflation, nobody can be sure how he will fare, whether his income and his assets will come out on the gaining or the losing side. Indexing is an imperfect and potentially very dangerous device to reduce this risk. If uncertainty, as most economists believe, is a serious cost, a mounting cost on that score must be debited to inflation.

Financial Institutions

The over-all effect of inflation in the financial sector, it has been said, is to shrink the financial system and reduce its effectiveness in promoting the movement of savings into investment. The demand for financial assets, in particular for money, on which no interest is paid, diminishes. Some financial assets may maintain their position by offering higher interest rates. But uncertainty about future inflation increases risk and therefore cost, and for many financial assets the protection of higher interest rates may not be available. The taxability of these inflation premia in any event, together with uncertain expectations about future inflation, give a speculative character to assets that ought not to be speculative.

The list of institutions that are being injured by inflation is long and makes depressing reading. Commercial banks, even though a relatively short-term asset structure may allow them to adjust interest rates to inflation, suffer an erosion of capital relative to assets and liabilities. Thrift institutions, with their longer term portfolios, have less flexibility with respect to interest rates on deposits and are exposed to disintermediation. If they attempt to attract funds by paying higher rates, their ability to accumulate and retain capital funds is affected.

Other financial institutions that play an important role in our society are injured. Private pension funds lose value in inflation. Whether the consequences fall upon the beneficiaries, because they may end up receiving less value in real terms, or upon the employer because he may be required to make up for the loss, the consequences will be felt. University endowments and foundations are likely to suffer.

Financial markets see their efficiency diminished. The uncertainties and risks of inflation favor the development of two-tier systems, in which the weak pay higher prices or are excluded altogether.

Regulated industries, such as utilities, find their profit margin squeezed as the regulatory lag prevents their rates from keeping up with rising costs. When that happens, their credit also suffers, their financing costs increase disproportionately and aggravate the effects of inflation. Governmental aid may become necessary. The ability of major industries to continue functioning as part of the private sector can be put in question. If inflation leads to experimentation with price controls, the threat of such developments could extend far beyond the presently regulated industries.

For all industry, the processes of profit accounting are violently disturbed by inflation. Business executives by now surely are as free of "money illusion" as the rest of the population seems to have become. They all know that the monetary unit cannot be relied upon as a measure of value and as an unchanging means of expressing contracts extending into the future. But there is a second kind of money illusion to which mainly businessmen are prone. It relates precisely to the measurement of profitability. Profit accounting is difficult even when prices are stable, because of uncertainties relating to devaluation of certain assets, to depreciation, and other variables. In inflation, these problems are intensified and compounded by new ones. Inventory profits arise which, according to the accounting method used, may or may not be carried down to the bottom line. Inventory profits, essentially capital gains, are of very limited value to the enterprise and in no way comparable to regular profits. They produce no cash flow for investment or dividends, since they are already embodied in the appreciated inventories. They nevertheless require payment of taxes and thus are in effect a net financial drain.

The inadequacy of depreciation charges on fixed assets in this kind of inflation is a familiar story. It would take very sharply accelerated depreciation to make up for the shortfall of depreciation charges resulting from the use of original instead of replacement cost.

The relative financial position of a firm as a net debtor or net creditor becomes important. Net creditors, i.e., firms whose monetary assets (those fixed in terms of dollars) exceed their monetary liabilities, lose purchasing power. Firms in the opposite position gain.

General price level accounting is one possible way of coming to grips with these complexities. It means to adjust a firm's balance sheet and income statement by some price index. The resulting picture can never be quite accurate, because no price index can correctly measure what happens to the particular inventory and fixed assets of any particular enterprise in times of inflation. General price level accounting provides a simplified check on the effect of inflation. In England, where they have had even more occasion than we have had to think about inflation, general price level accounting as a supplementary device is now being recommended to all corporations and is expected to be widely used. Some top managements may be surprised when they see the results.

To conclude, let me point to some distortions produced by inflation that are troublesome to central bankers but that fundamentally affect all producers and all consumers. Inflation drives a wedge between real and nominal values. For the central banker this means that neither interest rates nor changes in the volume of money or of credit mean what they say. We can adjust money and interest rates by a price index. But in the case of interest rates, it is not even past inflation, but expected inflation that must be supposed to guide borrowers and lenders. Nobody can be sure of these expectations, and no doubt they differ among different observers.

For the central banker, the net effect of these confusions has tended to be to make him place relatively more weight on monetary aggregates and relatively less weight on interest rates as guides to policy. The danger of error seems to be reduced by going along that route.

Inflation also tends to distort the term structure of interest rates. An important part of our financial system, especially housing finance, is based on the traditional assumption that on average, though by no means always, short-term rates will be below long-term rates. Inflation tends to reverse this relationship, because, so long as people expect inflation to slow down eventually, a lower inflation premium may be built into long-term interest rates than into short-term rates. Many factors besides inflation expectation influence the term structure of interest rates, of course. There is no reason to expect a firm relationship between short and long rates. But esoteric though the topic may appear, the consequences of short-term rates rising substantially above long-term rates are being felt severely in housing finance and other areas.

My listing of the consequences of inflation is far from complete. I could range farther afield and examine its social and political implications. In some foreign countries, where inflation has been even more virulent than in the U.S., these implications are becoming alarming. The threat that inflation poses to social and political stability is being widely discussed in Europe. American democracy is solidly based, but we have seen that we are not immune to the financial pressures that are being experienced in some countries, and we must take thought how to guard against finding ourselves in a similar position. The present inflation is not a minor malfunctioning of the economy. It is a fundamental threat. To end it will make worthwhile even very considerable sacrifices.

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