FOR RELEASE ON DELIVERY
WEDNESDAY, SEPTEMBER 25, 1974
9:30 A.M. EDT

MEANS OF COMBATING INFLATION

Remarks by

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

at the Conferences for Corporation Executives

Wednesday, September 25, 1974

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School of Advanced International Studies

Washington, D.C.

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The inflation summit is still looming ahead. But the foothills and lower peaks that have been scaled in the meetings thus far offer a fair preview of the state of the arts and opinion in the field of disinflation. On the whole, there have been few surprises and few new suggestions. This does not mean that the exercise has not been a fruitful one. It has focused attention on the problem, and it may help to build consensus. And if few previously unknown remedies have surfaced, the process of search nevertheless conveys a sense that nothing has been overlooked. That is valuable insurance.

The range of views expressed has been wide, but it would be wrong to interpret this as a polarization of opinions. The middle ground is well populated, and in some matters one can speak of a strong consensus. That is the case, obviously, with respect to the universal desire to see a serious recession avoided. Nobody, to my knowledge, has recommended deep

1/ The views expressed are my own and not necessarily those of the Members of the Board or its Staff.

recession as a remedy to inflation. Accordingly, there was widespread consensus that it would take a substantial amount of time to bring inflation down.

Gradualism

The desire to avoid recession implies a gradual approach. "Gradualism" was tried once before, and it was no roaring success. In the light of hindsight, however, criticism of the approach may have been overdone. An old inflation takes time to slow down. We have little choice but to try again.

A gradual approach has several implications. For one, it implies a policy seeking to keep GNP rising moderately, enough if possible to provide some increase in average per capita income, but with a degree of slack developing in the economy that would restrain inflation. This would avoid a sharp and sudden rise in unemployment which might force the authorities to shift gears, from fighting inflation to fighting unemployment, as has so often happened in the past. It means spreading the degree of slack that our community will accept more thinly over a longer period of time. For these reasons, it also means a more steady approach to monetary policy, as measured by the rate of growth of money and credit. Sharp ups and downs in the rate of expansion of money and credit, and especially a total cessation of growth in the money supply, as has sometimes occurred in the past, would not be in keeping with a gradual approach to disinflation.

The Old Time Religion

The wheelhorses of this disinflation campaign will have to be monetary policy and fiscal policy, as they have been in the past, and as the pre-summit discussion largely though not unanimously seems to suggest. Competent economic theorists can always find reasons why monetary or fiscal restraint is not appropriate to whatever happens to be the current situation, and today's current situation is no exception. One argument against monetary and fiscal restraint is that they both operate against excess demand, and that our present situation is not one of excess demand. At a time of widespread although diminishing shortages, however, there can be some question as regards even that assertion, for demand still is clearly excessive at least in some sectors. More broadly, it is not at all obvious that the economy is in a phase of cost-push inflation. Wages have been moving up rapidly, and some cost-push undoubtedly is present. But whether or not that is the predominant case remains debatable.

In any event, the view that monetary and fiscal restraint cannot be used against a cost-push inflation is dated. It goes back to the debate that ensued during the inflation of the late 1950's. As a matter of historical record, that inflation, whatever its characteristics, was liquidated by strong monetary and fiscal effort. But meanwhile the Phillips Curve, i.e., the trade-off between inflation and unemployment, has become the main instrument for analyzing inflation, at least for short-run periods. (Some observers, myself included, do not believe that for the long run such a trade-off exists.) The Phillips Curve does not distinguish clearly between demand-pull and cost-push inflation. It thus seems to open up a wider field for the application of monetary and fiscal restraint, if one accepts this type of economic analysis.

A more compelling consideration emerges as soon as one asks what could take the place of fiscal and monetary restraint. Those who argue that under certain conditions, and perhaps under those prevailing now, these restraints do not work, must have in mind some alternative instruments. They presumably would want to deactivate monetary and fiscal policy. Under present conditions, that would mean to accommodate numerous demands for additional credit and for additional government expenditures. This would require a sharp step-up in the rate of growth of money and of credit. It is hard to see what would prevent an acceleration of inflation in the presence of a great deal more money. The old time religion of fiscal and monetary restraint is simply inescapable, but we must also explore additional means to help us curb inflation.

Insulating Monetary Policy Against Its Side Effects

Monetary restraint, while aiming to bring down inflation, generates various undesirable and often very painful side effects. Unemployment is one, contraction of the housing industry is a second, strains in financial markets and in the balance of payments resulting from high interest rates are others. In the past, monetary policy has been constrained by the need to keep these side effects from becoming too severe. The functioning of monetary policy could be improved and its potential application broadened if these side effects could be overcome without relaxation of restraint.

A variety of means for accomplishing that end have been suggested. To hold down unemployment, public service jobs have been proposed. The employment statistics indicate that such a measure, properly implemented, could be highly effective not only in containing the over-all unemployment rate, but also in dealing with structural unemployment in those sectors which receive relatively little relief from cyclical expansions. Our present unemployment rate of 5.4 per cent conceals rather than reveals the true condition of the labor market. At one end of the spectrum, we have the unemployment of black teenagers at an incredible 30 per cent. This is a social problem of the first order which can be significantly ameliorated by public service employment, although much more than that may be needed. At the other end of the spectrum there is the group of married males with a present unemployment rate well below 3 per cent. If those among them with unemployment in excess of five weeks are regarded as having the principal problem, serious unemployment among married males turns out to be of the order of 1.5 per cent. This implies very little slack at the core of the labor market, and no severe harmful effects attributable to monetary and fiscal restraint in this critical area.

Public service jobs do raise the question how to pay for them. Higher expenditures with no offset simply lead to more borrowing and more money creation, with more inflation. Moreover, if unemployment is reduced, the restraint exerted against inflation by a given monetary policy will also be reduced. Higher taxes or noninflationary borrowing, i.e., borrowing outside the banking system, on the other hand, would reduce demand in other sectors of the economy and thus once more raise unemployment. Public service jobs therefore can only be a partial answer to the problem of muting the side effects of monetary and fiscal restraint on employment.

Something similar can be said of housing. The impact of monetary restraint upon the housing industry can be offset in part at least if the funds of the savers who temporarily abandon the thrift institutions are replaced by injection of public funds. This technique has played an important role in the current and earlier periods of restraint. It, too, however, turns out to be no panacea. The need of the respective government agencies to raise funds in the market in order to pass them on to home buyers puts pressure on financial markets and diverts funds from thrift institutions that would otherwise finance housing. Monetary policy can be insulated against its impact on the housing market, but only to a limited extent.

This picture is repeated a third time when we look at the side effects of monetary restraint upon the financial system as a whole. A restraining monetary policy need not aim at high interest rates. It may, as indeed has been the case of late, focus predominantly upon moderating the expansion of money and credit. But if there are strong demands in the market, those demands will cause interest rates to rise. In times of severe inflation, even nominally very high rates may not be high in real terms, i.e., after adjustment for price increases. Nevertheless, even nominally high rates can create problems for financial institutions that may have pushed too hard against the limits of prudence.

American financial institutions are strong, their liquidity is backstopped by the Federal Reserve as a lender of last resort, such few cases of insolvency as have occurred have been dealt with effectively by the FDIC;

the soundness of the banking system is protected, moreover, by a framework of detailed regulation and careful supervision. Nevertheless, the recent period of high interest rates has generated concern about the state of our markets and our institutions. A continuing effort to upgrade the condition of markets and institutions will have to be a part of the task of insulating monetary policy against its adverse side effects.

Still another area in which monetary policy may have unintended repercussions is the balance of payments. In the past, a high level of interest rates tended to attract funds from abroad, causing difficulties for monetary authorities in other countries. More recently, under floating rates, these flows have been much reduced. Now, however, high interest rates attracting foreign investors may exert an impact on the foreign exchange rates, raising the value of the dollar relative to other currencies. And since money and capital markets the world over are closely interrelated, high interest rates in the United States tend to affect rates elsewhere. Monetary policy has not been freed altogether from international constraints by the shift to floating exchange rates.

Fiscal Policy

The need for firm fiscal restraint, in the form of an expenditure cut of $5-10 billion with the ultimate aim of a strong budget surplus, has been emphasized in pre-summit discussions. Critics have argued that a budget cut poses the risk of recession and, not quite consistently, that cuts of the magnitude feasible mean little in the face of a $1.3 trillion GNP. There are good reasons, however, for emphasizing the role of fiscal policy.

Fiscal policy, for one thing, is far more understandable to the general public than are the arcanae of monetary policy. Rapidly mounting government expenditures accompanied by large deficits, moreover, clearly have contributed substantially to the present inflation. Finally, a tighter fiscal policy would reduce the government's borrowing in the capital market and, given a monetary policy that maintains a constant growth of money and credit, would lead to lower interest rates.

Energetic restraint of government spending is desirable for still another reason. Inflation has increased tax revenues by pushing individual taxpayers into higher tax brackets and by causing many corporations to report inventory profits on which they have had to pay taxes. Bringing the inflation to a halt will not alter the tax revenue flowing from the personal income tax. It will very materially reduce, however, the take from the corporate income tax. With inventory profits currently in the range of $35-40 billion, the extra corporate tax revenue obtained by the government may be of the order of $15 billion or more. This part of the revenue will not be lost overnight, but its shrinkage as inflation diminishes (or as corporations shift to LIFO inventory accounting) does call for corresponding expenditure restraint.

Counterproductive Proposals

A variety of often ingenious suggestions were made during the pre-summit meetings that, upon closer analysis, have one feature in common: their application would require printing more money. Proposals to combat inflation burdened with this side effect do not carry conviction. This applies, for instance, to well-meant suggestions to expand credit in order to expand productive investment in order to expand output. More output indeed would tend to restrain inflation, but not if it has to be financed by an expansion of money and credit.

Another well meant proposal aims at reducing prices by reducing the interest cost component of production. Since interest is undoubtedly a cost of production, lower interest rates, it is argued, would mean lower prices. What is overlooked is the need to expand money and credit in order to bring interest rates down even temporarily. Over a not very long period of time, monetary expansion of course would drive up prices, and rising prices would in the end give us higher rather than lower interest rates.

A third proposal of this kind is the "social contract" under which labor agrees to moderate its wage demands in return for a tax cut. Aside from the difficulty of negotiating and enforcing such a contract, the tax cut most likely would lead to more government borrowing, more money creation, and more inflation. Alternatively, if the tax cut offered to labor were offset by a tax increase on business and upper income receivers, a proposal of doubtful equity, the effect would be mainly to reduce saving and investment. That is not what we need at this time.

Wage and Price Controls

Surprisingly few voices were raised at the pre-summit meetings in favor of wage and price controls. This reflects, presumably, our recent experience with controls. The presently prevailing view differs sharply from what was probably a majority view when controls were first introduced in 1971. One can probably say that, in a non-monetary way, the nation was enriched by that experience. Controls started off working fairly well while they were new and while the economy had a lot of slack. When that slack disappeared while the controls aged, their effectiveness diminished while their cost increased. This experience, acquired at considerable cost, is now standing the nation in good stead.

Market Oriented Tax Devices Against Inflation

When I was still a professor and columnist and perhaps unduly inclined to flirt novel ideas, I designed two approaches to the control of inflation via the tax system that appeared in various learned journals as well as in Newsweek Magazine. Given the fact that the pre-summit meetings so far have not produced a great wealth of new ideas, I hope I may be permitted to quote some of my old ones.

One, developed jointly with Professor Sidney Weintraub of the University of Pennsylvania, calls for an increase in the corporate income tax on corporations granting excessive wage increases. A guideline for wage increases would be set by a government agency, taking into account productivity gains and some part of the going rate of inflation. Corporations would be free to grant higher increases if the market situation made this desirable, but they would have to pay a higher rate of tax. Since the corporate income tax is hard to shift in the short run, this tax would fall mainly on stockholders. The restraint, however, would fall upon wages. The tax would lend backbone to management in its negotiations with labor.

Conversations with tax experts suggest that such a tax would not be impossible to administer. The experience of the late unlamented wage and price control agencies, moreover, seems to show that it is indeed possible, by establishing a set of reasonable if arbitrary rules, to determine the magnitude of a wage increase with precision. The Internal Revenue Service has stood ready, as a matter of fact, to disallow for tax deduction purposes wage increases denounced to it by the then Pay Board as excessive, and I understand that the World War II price controls did produce cases of this kind. In contrast to most other "anti-inflationary" tax proposals now current, this one has the additional virtue of raising revenue for the Treasury.

My second proposal likewise would be a revenue raiser, although its principal purpose is another. A glance at the structure of our national income shows that labor's income (compensation of employees) accounts for approximately 75 per cent of the total while profits after taxes and after inventory profits, which are not part of national income, account for about 4 per cent. (Farmers, small businessmen, landlords, savers account for most of the rest.) It is obvious, therefore, that restraints placed on corporate profits would accomplish little to halt inflation, while restraints upon wages could accomplish a great deal.

These figures illustrate why researchers have tended to find that prices, in manufacturing and services at any rate, are largely determined by labor costs. Wages are the great bulk of all costs, including profits. A slowing in the rate of wage increases, therefore, would probably have little effect upon labor's share in the national income. Price inflation would diminish along with wage inflation, and the researcher's prediction that real wages would not be significantly affected might well be validated. The inverse, however, would be very unlikely to occur: a reduction in profits would not reduce prices sufficiently to leave profits in real terms unchanged.

There exists consequently a great difference between a reduction in wage increases and a reduction in profits. Nevertheless, labor has made clear that it views corporate profits as the principal competitor of wages for a share in the national income. While the data on relative shares just cited do not confirm that view, from the vantage point of a bargaining table this may well be the impression formed by the representatives of the union and of management. The concerns of labor arising from that impression might be allayed, and a basis might be created for moderation in wage demands, by the following approach.

Labor's concern that the share of profits would rise if wage restraint were accepted could be allayed by a tax to stabilize the share of corporate post-tax profits in the national income. A benchmark would have to be set for corporate profits share, possibly on the basis of a historical average. If during a period of voluntary wage restraint profits should rise above this benchmark share, the corporate tax rate would be raised sufficiently to bring it back to the benchmark. The tax would have to be assessed once all the data had been collected, which presents an inconvenience but not a decisive one. In all probability, if the finding of a dominant influence of wages upon prices is correct, wage restraint will not lead to an increase in profits. The surcharge on the corporate tax therefore would not go into effect. If it did, it would affect all corporations equally, insofar as they had taxable income, high or low. It would thus avoid the familiar disincentive effects of an excess profits tax.

The proposal is not dependent on the enforceability of a social contract. If a wage guideline were established and the tax enacted as the price of acceptance of the guideline, and if the guideline were subsequently widely ignored, profits presumably would not rise and hence there would be no additional tax.

I shall say no more about my old proposals. Nobody can say today whether they present a practical approach to the problem of curbing inflation. Their purpose is to enlist the forces of the market on the side of price stability. I continue to believe that they are deserving of further exploration.

Meanwhile the need for action continues to be upon us. We must work with the tools that are in hand, and that we are doing. Beyond that, we must keep exploring new possibilities, not only at the pre-summits and the summit meeting on inflation, but at all times hereafter. This is an important challenge, and I believe that the members of this audience and American executives generally have an important role to play in responding to it.