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Inflation: The Fundamental Challenge to Stabilization Policies

Remarks of Arthur F. Burns,  
Chairman, Board of Governors of the Federal Reserve System

before the

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of the American Bankers Association

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We have gathered together as representatives of government and the banking industry to discuss our problems, experiences, and concerns about financial affairs. Each of our countries has specific problems that are peculiar to the character of its own economy. In nearly all of our countries, however, the fundamental challenge to current stabilization policies is the persistence of inflationary pressures.

What I should like to convey to you today is the following simple message: Although the forces making for inflation in modern society are strong and pervasive, these forces need not prevail. Stabilization policies can be formulated and executed in a way that will permit our economies to enjoy the benefits of prosperity without inflation. I do not minimize the difficulties of meeting this challenge, but I am convinced that success is possible.

We are living now in an inflationary climate. In the United States periods of strong upward price pressures over the past quarter century have been episodic. Interspersed between them have been years of relative price stability. But the period since 1964 has witnessed stronger and more widespread cost and price pressures than in the previous inflationary outbreak of the mid-1950's. And the current episode of inflation has lasted longer than any other since the end of World War II.

In most other industrial countries, price performance over the past two decades has been poorer than in the United States. However, after 1964 the American price level began to move up briskly and our inflation from 1966 to 1969 tended to outpace that in Europe. More recently, we see an acceleration of cost and price pressures in Europe and Japan.

In these circumstances, it should not be surprising that so many businessmen and consumers believe that inflation is inevitable. This has happened before. During the 1950's, the notion that creeping inflation was endemic to a modern economy was widely held in the United States. Yet the period from 1958 through 1964 was marked by reasonable price stability. We in government therefore have a responsibility, I feel, to make it convincingly clear to everyone that inflation is not an economic necessity and that it will not be accepted as an inevitable course of events.

I believe there are grounds for optimism about our ability to achieve and maintain reasonable price stability, and to do so without incurring excessive costs in terms of unemployment and lost output. I reach that conclusion from long exposure to the inflationary problem in the United States. The basic sources of inflation in all of our economies are similar, however, and what we can learn from American experience may also be applicable elsewhere.

What are the sources of the inflationary bias that is presently troubling us? On a first view, the root of the difficulty seems to be the broadening of the social aspirations that have been shaping our national economic policies, and especially the commitment to maintain high levels

of employment and rapid economic growth. For several decades, the primary concern of economic stabilization policies was to avoid substantial or prolonged declines in the level of economic activity -- declines of the sort that had plagued industrialized economies for a century or more. As we gained experience in moderating business downturns, our standards of economic performance became more exacting. Now, we are not prepared to accept more than brief departures of our economic growth rate from its full employment path.

Improvements in our ability to control cyclical fluctuations in business activity have also emboldened us to search for ways to increase the potential growth rate of our economies -- through better education and training of the labor force, through larger investment in public facilities, and through stimuli to private investment in fixed capital. In this effort, too, we have achieved some measure of success. In the short run, however, I suspect that these policies have added more to aggregate demand than to aggregate supply.

Another source of inflationary pressure in recent years has been the rise of governmental expenditures for social welfare. The consequences for the Federal Budget in the United States have been dramatic. Since fiscal year 1965, Federal expenditures for health, income security, veterans' benefits, education and manpower, and community development and housing have more than doubled. And as we look to the future, we must expect substantial further increases in the level of government expenditures to help halt the decay of

our central cities, to bring air and water pollution under control, to provide added financial assistance to beleaguered state and local governments, to finance basic research in areas where private incentives are insufficient, to provide better housing for the less privileged, better medical services to the indigent and the aged, improved job training-- in short, for the host of things our people have come to expect their government to provide.

The present world-wide inflationary trend may thus be ascribed to the humanitarian impulses that have reached such full expression in our times. This explanation, however, encompasses only part of the truth. As every economist knows, the growth of aggregate demand that has been generated by our social aspirations could, in principle, have always been offset by monetary and tax policies, supplemented by more selectivity in public expenditures.

The present world-wide inflationary trend must, therefore, also be recognized as evidence of the shortcomings of economic stabilization policy. Serious inflationary problems are always traceable to excessively expansionist monetary and fiscal policies or to the failure of such policies to offset the effects of excessively exuberant demand in the private sector. This, however, is something that admits of correction.

The reason for my optimism about the prospects for long-run improvement of our price performance is a deep faith in the learning process. True, we have made many mistakes in the formulation and administration of our

national economic policies, and we will doubtless make some mistakes in the future. But we can also learn from past experience how to distinguish the paths that need to be taken from those that must be shunned if we are to win the ever-recurring bouts with the threat of inflation.

Let us consider briefly the experience with stabilization policy in the United States, drawing on the record of the past few years by way of illustration. These years offer, I believe, lessons that we cannot afford to ignore.

One of the serious economic blunders of recent years was the failure to alter the course of fiscal and monetary policies when early warnings of inflation began to flash. Late in 1964, signs of growing pressure on our nation's resources were already multiplying and these signs became stronger and more widespread in the first half of 1965. With the economy moving rapidly toward full employment, the time had come for backing away from the stimulative policies pursued in the earlier years of the 1960's. But precisely the opposite course was taken -- both fiscal and monetary policies became substantially more stimulative during 1965.

In my judgment, the fateful policies of 1965 stemmed only in part from the inadequacies of economic forecasting. It is true that attention had been diverted from the problems of inflation by the experience of the previous 5 or 6 years, when much slack existed both in industrial plants and the labor market and the price level moved within a narrow range.

By the late summer of 1965, however, it was entirely clear that storm clouds were gathering on the economic horizon. The unemployment rate had moved close to the 4 per cent target, while the rate of utilization of industrial capacity -- which was already high -- still kept rising. Yet, despite the strains under which industry was already operating, the economy was called upon to shoulder a much enlarged military burden in Vietnam without any change in monetary or fiscal policy. Monetary policy continued on its expansionist track during the latter half of 1965 and fiscal restraints of material consequence were postponed much longer.

The mistakes of stabilization policy in 1965 reflected an unwillingness to face up promptly to the urgent need for restrictive actions on the fiscal and monetary front. It was soon found, however, that by eschewing an ounce of prevention, a pound of cure had become necessary. Inflationary forces gathered such momentum that it took stern measures in subsequent years to eliminate excess demand.

Another deficiency in the formulation of stabilization policies in the United States has been our tendency to rely too heavily on monetary restriction as a device to curb inflation, rather than on a balanced program of fiscal and monetary restraints. There are several reasons why excessive reliance on monetary restraint is unsound,

First, severely restrictive monetary policies distort the structure of production. General monetary controls, despite their seeming impartiality, have highly uneven effects on different sectors of the economy. On the one hand, monetary restraint has relatively slight impact on consumer spending or on the investments of large businesses. On the other hand, the homebuilding industry, State and local construction, real estate firms, and other small businesses are likely to be seriously handicapped in their operations. When restrictive monetary policies are pursued vigorously over a prolonged period, these sectors may be so adversely affected that the consequences become socially and economically intolerable, and political pressures mount to ease up on the monetary brakes.

Second, the effects of monetary restraint on spending often occur with relatively long lags. The initial actions of a central bank to moderate the pace of expansion in money and credit may come at a time when liquidity positions are relatively ample in the commercial banking system and elsewhere in the economy. Loan commitments to businesses by banks and life insurance companies may be sizeable, and other financial institutions may have committed large sums to the mortgage market based on expected inflows of funds. For a time, therefore, the effects on spending of the slower rate of expansion of bank reserves will be cushioned. Moreover, the length of lags in the response of spending will vary from one period of monetary stringency to another, depending on the state of liquidity, the expectations of the business and financial community, and a variety of other factors.

Primary reliance on monetary policy to restrain inflation thus places a high premium on accurate forecasting of both the strength of private demand and the temporal effects of monetary restraint on spending. Because the lags tend to be long, there are serious risks that a stabilization program emphasizing monetary restraint will have its major effects on spending at a point in time when excess demand has passed its peak. The consequence may then be an excessive slowdown of total spending and a need to move quickly and aggressively toward stimulative policies to prevent a recession. Such a stop-and-go process may well lead to a subsequent renewal of inflationary pressures of yet greater intensity.

Something like this happened, I believe, in 1966 and early 1967. The monetary brakes began to be applied with considerable force in the spring of 1966, and they began to take their greatest toll in spending in the fall months of that year. By that time, the adverse structural effects of excessive monetary restraint had become obvious to everyone, and some modest fiscal action was taken to help slow the economy. Just about that time, however, the rate of consumer spending relative to income declined rather sharply. With the expansion of total final demand for goods and services tapering off, monetary policy then moved aggressively toward ease to ward off a threat of recession. As things turned out, the adjustment proved to be mild and short-lived, and by the latter half of 1967 we found ourselves in an aggravated condition of economic overheating.



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We need to recognize, of course, that there is considerable uncertainty also about the effects of fiscal policy on the performance of the economy. The direct effects of changes in Federal expenditures or tax rates on private incomes and spending are themselves often difficult to predict. But the overall impact of fiscal policy must also take into account the effects of budgetary changes on interest rates and hence on private spending. Our knowledge about these effects is sketchy. Much will depend, of course, on the precise nature of the actions taken and on the state of private expectations at the time.

In recent years, we have tended to overestimate our knowledge of economic processes, and how they are influenced by monetary and fiscal policies. We have, for example, adopted temporary increases in taxes as though we knew with reasonable certainty that the economic situation a year hence would warrant their removal. The economic impact of such taxes has been considered without due regard to our limited understanding of the effects of temporary taxes on consumer and business spending decisions. Furthermore, growth rates of the major monetary aggregates have been permitted to vary over an extremely wide range, notwithstanding our hazy perception of the timing and magnitude of the economic effects of such variations. There has been much loose talk of "fine tuning," when the state of knowledge permits us to predict only within a fairly broad band the course of economic development and the results of policy actions.

Improvement in the formulation and implementation of stabilization policies requires full recognition of the great uncertainties with which we must live. This means that we need to adopt a cautious approach to large changes in the intensity of monetary and fiscal policies--avoiding extreme courses of action unless the evidence clearly indicates that exceptional policy moves are needed. Furthermore, the uncertainties inherent in the use of any single instrument of policy suggest that the prudent course is to adopt a balanced program that relies on prompt adaptations of fiscal as well as monetary policy.

Let me turn now more specifically to the current inflationary problem in the United States, and suggest what these lessons of recent experience seem to imply for the course of monetary and fiscal actions.

First, I want to note that we have made much more progress than is generally realized in getting the inflationary forces of recent years under control. The excess demand that bedeviled our economy during the past four or five years has been eliminated. In recent months, total real output has declined somewhat. Industrial production has dropped faster and is now about 2-1/2 per cent below its peak last summer. Demand for labor has moderated, the unemployment rate has increased, and the degree of unused industrial capacity has also risen.

Throughout this phase of economic sluggishness, there has been a risk that the decline in industrial output would intensify and

spread across the economy, with the business slowdown taking on the characteristics of a recession. Thus far, the pervasive and cumulative characteristics of a recession have not developed--largely, I believe, because of the continuing strength of business investment in fixed capital. It seems highly probable, moreover, that the business slowdown will not extend much further, and that before long we will be enjoying a resumption of growth in industrial output and employment. If that proves to be the case, the success we will have had in slowing aggregate demand without precipitating a recession will have been a notable achievement.

We have been less successful than we would have liked in moderating the advance of prices, and also less successful than we might have expected on the basis of past experience. But there are some signs of progress in that area, too. After seasonal adjustment, the rate of increase in consumer prices slowed in February and again in March. The level of wholesale prices remained unchanged in April for the first time in a year and a half, as prices of some agricultural products fell sharply. The price rise for industrial commodities in March and April was the smallest since last July.

It is clear, nonetheless, that the average rate of price increase during recent months is far too high. The question might be raised, therefore, whether our current inflationary illness could be cured more quickly with a shock treatment designed to rid the patient, once and for all, of the troublesome disease.

Such a prescription would, I believe, be unsound as well as unacceptable. The inflationary developments we are now experiencing do not reflect the present state of balance between aggregate demand and supply. Rather, they are the aftermath of economic overheating that existed earlier and which is still having lagged effects on wage rates, on other costs, and hence on prices. We are in a transitional period of cost-push inflation, and we therefore need to adjust our policies to the special character of the inflationary pressures that we are now experiencing.

An effort to offset, through monetary and fiscal restraints, all of the upward push that rising costs are now exerting on prices would be most unwise. Such an effort would restrict aggregate demand so severely as to increase greatly the risks of a very serious business recession. If that happened, the outcries of an enraged citizenry would probably soon force the government to move rapidly and aggressively toward fiscal and monetary ease, and our hopes for getting the inflationary problem under control would then be shattered.

It would be an equally serious mistake, however, for the central bank to supply money and credit in sufficient quantities to permit businesses simply to pass on all cost increases to their customers. Readiness to validate the pressures of costs on prices, through generous provision of money and bank credit, would greatly increase the probability of a later resurgence of excess demand. This, too, must be avoided.

The right course for monetary policy is, I believe, a cautious approach that avoids both of these extremes. In recent months the major monetary aggregates have been following a path of moderate expansion--a path that provides added insurance that the current economic slowdown will not cumulate, but at the same time is consistent with avoidance of excess demand later this year and on into 1971. The adequacy of growth in supplies of money and credit to finance increases in real output and employment will, of course, depend heavily on the movement of costs and prices. As I noted a moment ago, it would be inappropriate for the central bank simply to validate the effects of all cost increases on prices. Consequently, the longer inflationary wage settlements and pricing decisions continue, the larger may be the shortfall of economic growth from its potential.

In the months ahead, we may be witnessing economic developments that will test patience--with costs and prices continuing to advance despite the slack that exists in markets for goods and for productive services. It seems likely that we will hear an increasing number of suggestions that additional steps need to be taken to moderate the rise in wage rates and the advance of prices--steps that could involve the government more directly in the operations of the private economy.

Other countries that have depended on specific wage-price policies--or incomes policies, as they are frequently called--have achieved relatively little success, and the same can also be said

of our own experiment during the sixties. Nevertheless, we should not close our minds to the possibility that an incomes policy, provided it stopped well short of direct price and wage controls and was used merely as a supplement to over-all fiscal and monetary measures, might speed us through this transitional period of cost-push inflation. I recognize that an incomes policy may not have a lasting effect on the structure of costs and prices if its use is restricted to a transitional period of cost-push inflation. Moreover, it seems clear to me that an incomes policy applied over a long period would be completely impractical. Even with these reservations, however, there may be a useful--albeit a very modest--role for an incomes policy to play in shortening the period between suppression of excess demand and restoration of reasonable price stability.

Of course, primary reliance in the battle against inflation must always be placed on policies that impinge on aggregate demand. It is of fundamental importance that monetary and fiscal policy work together, in this regard, in the months ahead. If the tempo of economic activity picks up later this year, as may now be reasonably anticipated, the task of ensuring that this recovery does not become too brisk--thereby threatening a re-emergence of excess demand--should not fall on monetary policy alone. Fiscal policy must do its share.

The Budget set forth by the Administration in January called for a small surplus for fiscal 1971. Since January, there have been some modifications in the projected course of Federal expenditures as a result of actions taken by the Congress and the Administration. Thus far, the most significant change in projected expenditures has come from the acceleration of the Federal pay raise, which added a little over \$1 billion to expenditures in the current fiscal year, and a like amount to prospective outlays in fiscal 1971.

During prior periods of economic slack, a small change of this kind in the outlook for Federal expenditures would have created scarcely a ripple in financial markets. In recent weeks, however, reactions in financial markets have been dramatic. Interest rates have increased sharply, with yields in the long-term markets rising above the peaks of late last year. A number of factors have been responsible for this change in market expectations, but concern about Federal expenditures appears to have been the catalytic agent. Participants in financial markets greeted the news of the pay raise as if it were the first in a series of steps that would let down the bars on Federal spending, and recent developments in Indochina have intensified this feeling.

Perhaps these reactions are just one more evidence of the strength of the inflationary fears and expectations still present in our economy. However, the public is also mindful that promises of fiscal

restraint emanating from the Executive and the Congress have, time and again, been unfulfilled. We must not permit that to happen in the year ahead.

At this juncture of history, the business and financial public is deeply concerned that the Federal budgetary process may have gotten out of hand in recent years. There is some basis for this concern. Reforms of the Federal budgetary process are, I believe, essential to long-run improvement in conducting our stabilization policies and our battle against inflation.

For the long run, there are a number of budgetary reforms that will be needed to keep Federal expenditures under control. Ultimately, I think the concept of zero-base budgeting will have to be adopted in order to weed out expenditures on outmoded programs whose costs have long since exceeded their benefits. In other words, we need to have each year a careful review by the Budget Bureau and the Congress of the total spending proposed on each program, not just the proposed increases in spending.

Progress toward this objective of zero-base budgeting might be speeded by personnel rotation among the major divisions of the Budget Bureau, so that a fresh point of view would be brought to bear on the budget requests of the various departments of government. But for the immediate future, the single most constructive step that could be taken would be a legislative ceiling on Federal expenditures for the coming fiscal year. This ceiling should be tight enough to give reasonable

assurance that Federal expenditures for fiscal 1971 do not rise appreciably above the level projected in the Budget last January. Alternatively, if expenditures threaten to rise significantly above that level, taxes should be provided to cover the excess.

In conclusion, I believe that the prospects for a return to reasonable price stability are brighter than is generally recognized. Excess demand in our economy has been eliminated. After a long period of overheating, the first signs of moderation in price behavior--though halting and slow--have begun to appear. It seems probable, moreover, that economic recovery, as it develops, will proceed satisfactorily and yet not strain our physical capacities.

The sources of long-run inflationary bias in the United States, as elsewhere in the world will, of course, continue to operate. But by applying sensible monetary and fiscal policies, we can check the inflationary tendencies that emanate from the pursuit of our social and economic goals. The clearest lesson of the past few years is that delay in coping with inflationary pressures merely compounds the difficulties that need to be faced later. Fortunately, this basic fact is now more widely recognized in the United States and in other industrial countries than it was ten or even five years ago.

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