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TESTIMONY OF

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before the

SENATE BANKING COMMITTEE

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Last week, President Carter set forth a new program to combat inflation -- the most difficult and intractable economic problem our country has faced since the Great Depression of the 1930s. Inflation in the United States has averaged 6-1/2 percent a year over the past decade. Two recessions -- one of them the largest in the post-War era and a fling at wage and price controls did not stop the inflation.

The importance of succeeding in the task we have undertaken can hardly be overestimated. We must reduce inflation to have any realistic hope of maintaining a strong economy and realizing the economic and social goals that are the hopes and dreams of all Americans.

This Administration does not propose to deal with ~~inflation by creating a recession and sharply rising unemployment,~~ nor will we impose mandatory wage and price controls. I have said on numerous occasions that this Administration is philosophically opposed both to putting the economy through the wringer of recession and to the use of mandatory wage and price controls except in the event of national emergency. The philosophical objections to those two kinds of measures are as strong now as they ever were. But those approaches were not rejected simply for philosophical reasons. They were rejected because they do not work. Both approaches have been tried before and were found wanting.

There are those who say that the present program cannot work -- either because private sector cooperation is voluntary, or because the Federal government has not taken forceful enough action to reduce its own contribution to inflation. Such a judgment reflects a lack of understanding of what this program is all about and, more fundamentally, of the unshakeable commitment of the President and his Administration to making it work.

In my testimony this morning, I will indicate why the program announced by the President is the only practical alternative for combating inflation in the U. S. economy. I will also discuss the specific actions that the Federal government will take to reduce inflation. Finally I will set forth my reasons for believing that the program will be successful.

Alfred Kahn and Barry Bosworth, the Chairman and Director of the Council on Wage and Price Stability, will subsequently outline the standards for pay and price increases established by the President, and the measures that the President is prepared to undertake to encourage compliance with the pay and price standards and to deal with inflation in particular sectors of the economy.

Inflation and Aggregate Demand Policy

The inflation that is currently damaging our economy did not begin during the Carter Administration. It is a problem whose roots extend back for more than ten years. The history of inflation and the efforts to combat it over that period contain important lessons from which we can

profit. If we ignore them, we may be doomed to repeat the mistakes of the past.

The current inflation began during the late 1960s when the economy reached very high levels of resource utilization. The unemployment rate was less than 4 percent in every year from 1966 through 1969, and in all of those years the actual output of our economy was above the potential level at reasonably full employment of our labor and capital resources.

The major factor initiating inflation during the mid-1960s was excess demand, as the economic stimulus from Vietnam war expenditures was added to an economy already approaching high employment. As a result, wages and prices both moved up more rapidly. For consumer prices, the rate of inflation rose from less than 2 percent in 1965 to over 6 percent in 1969.

The emergence of excess demand in 1966 occurred at a time when voluntary guideposts for wage and price behavior were in place. How much those guideposts reduced the rate of inflation in the early years of the 1960s has always been a matter of dispute. But there is no doubt that in the climate of economic overheating that developed in late 1965 and 1966, the voluntary guideposts lost their chances of success. By the end of 1966, that fact was clear to everyone, and the guideposts were dropped by the Johnson Administration, although efforts to influence particular wage and price decisions continued.

A second burst of inflation -- which began in 1972 -- was also due, in part, to excess aggregate demand. Both monetary and fiscal policies were very expansive during that period. Between the fourth quarter of 1971 and the first quarter of 1973, real GNP grew at a very rapid 7-3/4 percent annual rate. As a result, unemployment dropped sharply, and capacity utilization reached high levels, especially in the materials sector.

The upward pressure on prices was greatly augmented in 1973 and 1974 by a series of large, external shocks to the American economy -- a worldwide crop shortage followed by a quadrupling of world oil prices. The value of the U.S. dollar in exchange markets declined by close to 20 percent between mid-1971 and mid-1973 causing a rapid increase in ~~the price of U.S. imports and in the demand for U. S. exports.~~ Demand for U.S. goods was also augmented by a simultaneous economic expansion in all major industrial nations of the world, which accentuated the problem of tight domestic capacity here in the U. S.

Moreover, food prices surged in 1973 and 1974, reflecting a series of poor world harvests beginning in 1972, and the steep increase in OPEC oil prices in late 1973 caused the energy component of the CPI to rise by nearly 22 percent in 1974 alone.

For a time, these pressures on costs and prices were held in check by mandatory wage and price controls that were

rigid and comprehensive. The underlying inflationary forces were so powerful and the consequences of detailed controls so disruptive, however, that the controls had to be gradually relaxed and ultimately removed altogether in the spring of 1974. The pent-up inflationary pressures were then released, and in subsequent months costs and prices exploded.

Each of the two major episodes of the last decade, in which inflationary pressures mounted rapidly, was followed by serious recessions. But the accompanying sharp rise in unemployment and excess capacity did not succeed in eliminating the inflation, and indeed did not bring it significantly below 6 percent. The momentum of a long-standing inflation -- in which wages and prices chase each other, supported by expectations that inflation will continue -- is a powerful force tending to sustain inflation even when the originating causes have disappeared.

There are several basic and inescapable truths that emerge from this recent history from which we can benefit. First, standards for wage and price behavior -- whether voluntary or mandatory -- will not be effective if excess demand pressures are allowed to arise or if outside factors push up costs and prices strongly. Second, aggregate demand policies of fiscal and monetary restraint, used alone, will collide with the strong momentum of inherited inflation, and will reduce output and employment far faster than they reduce inflation.

A successful attack on inflation must, therefore, be a balanced one which attacks simultaneously both aspects of the problem -- combining overall demand management to create an economic climate in which inflation can be reduced with measures to break the momentum of the price-wage spiral.

Managing Aggregate Demand

We must achieve and maintain a balance between aggregate demand and supply that makes possible a reduction of inflation. This requires that we follow prudent and cautious fiscal and monetary policies to avoid upward pressures on wages and prices from the demand side. In such a climate, the forces of demand and supply in markets will be working to support the effects of the pay and price standards in limiting price and wage increases.

Achieving an appropriate balance between aggregate demand and supply will require that the economy grow at a moderate rate, lower than the increases of the past two years. In 1977, the economy grew at a 5-1/2 percent rate. This year we expect a 3-3/4 percent growth. To provide the level of balance between demand and supply needed to support progress against inflation, a lower growth target -- on the order of 3 percent or slightly more -- will be required next year.

This growth rate is about in line with our economy's long-term growth potential. Its achievement would keep the unemployment rate from rising. This Administration has by no means given up its commitment to make further progress

on unemployment -- especially to lower the extremely high unemployment rate among minorities. But the best hope for doing that lies in a combination of targeted measures to deal with structural unemployment and overall economic policies which help reduce inflation.

What are the Alternatives?

The President's anti-inflation program, as I said, is a balanced attack against the multiple sources of inflation. There are two major groups of critics of this balanced approach. On the one side, there are those who urge sole reliance on very harsh monetary and fiscal restraint as a means of wringing inflation out of the upturn. On the other side, some have urged the adoption of mandatory and comprehensive wage and price controls. In my judgment, reliance on either of these prescriptions would be economically dangerous and politically naive.

Some skeptics have argued that the shift in emphasis that the Administration has made in its aggregate demand policy is not enough. They insist that the way to defeat inflation is to apply fiscal and monetary restraint very harshly -- to make wholesale slashes in budget expenditures and to slam on the monetary brakes.

We know from experience what such a course of action would produce, since we have travelled that route before. Starting in 1969, our country sought to deal with the Vietnam war inflation solely by stern measures of monetary and

fiscal discipline. Since the source of the inflation was excess demand, monetary and fiscal restraint was indeed called for. But excessively restrictive policy actions produced results that were a bitter disappointment.

In late 1969, a recession began that reversed much of the reduction in unemployment that had been achieved over the prior decade. By the end of 1970, the rate of unemployment had risen to 6 percent. Yet inflation continued unabated. The increase in consumer prices did moderate in 1970 -- but only because of a slower rise of food prices. Prices of nonfood commodities and services rose just as fast in the slack markets of 1970 as they had in the overheated markets of 1969. Moreover, the increase in average hourly earnings in the private nonfarm sector of the economy -- our best ~~measure of average wage rates~~ -- did not decelerate at all in 1970, even with unemployment nearly half again as high as in 1969. The inflation proved to be impervious to the shock treatment of severe monetary and fiscal restraint. And, after two and one half years of disappointment, the "game plan" was abandoned. Mandatory wage and price controls were introduced and a program of economic stimulus put in place.

In 1973 and 1974, our country ^{tried} once again to combat inflation with very tight monetary and fiscal policies. And, once again, a recession was created -- this time, the worst recession in forty years.

The rate of inflation did recede in the first half of 1975, but this moderation was due less to the recession than to the termination of special factors affecting prices in 1974. Food supplies improved, the OPEC oil price increase worked its way through the economic system and the one-time adjustment of wages and prices after the removal of controls finally ended. But the rate of inflation -- with unemployment extremely high and excess industrial capacity extensive -- remained in the 6 to 6-1/2 percent range, about the same rate that had prevailed, on average, since 1969.

If some increases in economic slack -- higher unemployment rates and larger amounts of idle capacity -- led quickly to moderation of price and wage increases, a harsh, but short-lived policy of demand restraint might be worthwhile. In fact, ~~however, we live in a world in which prices and wages are~~ relatively insensitive to the degree of slack in labor and product markets.

Very strong doses of monetary and fiscal medicine, therefore, do not produce the desired results on the rate of inflation. Instead, they lead mainly to economic hardship for workers and business alike. Moreover, as we have seen in the years since 1970, prolonged economic slack depresses business investment and contributes to a slowdown in productivity that simply exacerbates the long-run inflation problem. Inevitably, as the ranks of the unemployed swell and factory closings mount during a recession, the public grows increasingly impatient.

Demands to "do something: become insistent, and eventually the effort to deal with inflation by creating recession is abandoned.

We need an anti-inflation policy that produces long-run results — we do not need another bout of stop-and-go.

Mandatory Wage and Price Controls

We also know from experience that mandatory wage and price controls are ineffective in combating inflation. Oddly enough, this lesson seems to have been forgotten in just a few short years. Let me therefore review a few of the salient developments of the period from mid-1971 to early 1974.

The period of controls led to a rediscovery of the ~~fundamental economic principle that changes in relative~~ price and wage rates play a vital role in allocating resources among competing users in a market economy.

When controls were first imposed in 1971, supplies of fuel oil were ample, and prices were low relative to those for gasoline and other refined petroleum products. The initial price regulations therefore tended to lock in an abnormal set of relative prices for refined products. The result was predictable. Producers tended to produce more of the product that was most profitable -- gasoline -- and so shortages of fuel oil subsequently developed.

Difficulties of this kind continued and multiplied. Since import prices were not controlled, suppliers of beef, lumber and other products shipped their wares to Canada and then reimported them at uncontrolled prices. The extra transport costs added still more to inflation. Producers of aluminum, copper, and zinc found that it was more profitable to export their output than to sell it in domestic markets, and so supplies of those metals became virtually unavailable to domestic users.

In late 1973 and 1974, we were struggling to increase the output of coal because of the oil embargo and the subsequent sharp increase of crude oil prices. But increasing production of coal was hampered by shortages of mine roof bolts. Production of that small but essential item, it

turned out, had become unprofitable.

During the 60-day price freeze imposed in mid-1973, prices of feed grains, which were exempted, rose substantially. But meat prices were frozen and production of livestock and poultry became unprofitable. Farmers, therefore, slaughtered livestock and poultry that would otherwise have become available for consumption. We are still living with some of the consequences of that episode, in the form of reduced cattle herds and rising meat prices.

The Price Commission struggled to deal with problems of this kind, while the Pay Board grappled with repeated complaints that the limitations on pay were inequitable and were leading to difficulties in obtaining needed workers in expanding industries. By the end of 1972, some 4,000 people in the Federal government were employed to administer the program, and the burden of administration was steadily rising. Costs in the private sector, moreover, almost certainly exceeded by a wide margin those experienced by the Federal government. (In this connection, I was interested to note that in his press conference last Tuesday, AFL-CIO President Meany estimated it would take about 250,000 to 300,000 additional Federal workers to administer the comprehensive scheme of wage, price, and income controls he was recommending.)

As the controls were relaxed and modified to deal with emerging problems, the rate of inflation began to accelerate.

By the first quarter of 1973, the rate of inflation was up to 6-3/4 percent - and it continued to move up until it reached the double-digit range.

Mandatory controls over wages and prices in the early 1970s were a failure. They were extremely costly. They led to serious shortages and inefficiencies. And they did not successfully limit inflation. As a consequence, economic and political pressures for removal of the controls became overwhelming.

Such an outcome was inevitable. Indeed, in broad outline, our own experience in the U.S. merely repeated that of some Western European countries that resorted to wage and price controls in an effort to suppress inflation. The simple fact is that no government has, or can acquire, the amount of information required to adjust prices and wages as needed to keep a complex modern economy functioning smoothly.

The temptation to push a single button, and deal with the decade-long inflation, through a simple nostrum, must be resisted. The two available nostrums -- the abrupt and severe application of monetary and fiscal restraint or mandatory wage and price controls -- are a delusion. Despite their appearance of vigor and toughness, history has shown them to be ineffective and dangerous, and in the end, for both economic and political reasons, unsustainable.

A Responsible Course of Action

In choosing the course of action set forth by the President last week, this Administration benefited from the lessons of history. We recognize that a successful anti-inflation program must come to grips with the complex nature of the problem we face. The current inflation has been troubling our economy for more than a decade and it cannot be defeated overnight. We will give the fight against inflation top priority -- not just today and tomorrow, but for the foreseeable future. We know that policies to combat inflation which are not grounded in solid economic principles will soon lose their emotional and political appeal. We must be firm but sensible in our application of guidelines for private behavior.

That is the kind of program the President has adopted. It is the best way to reduce inflation in the American economy. Indeed, it is, in my judgment, the only practical course of action open to us.

The President's Anti-Inflation Program

Let me now turn to the specifics of the anti-inflation program, and particularly to the actions to which the Federal government is committed to bring inflation under control.

Earlier this year, the President outlined the framework of a voluntary program that required the cooperation of government, business, and labor. These efforts have not been enough. Stronger measures are required. Therefore, the President has taken steps:

- o to intensify the anti-inflation efforts of government by
 - adopting a more stringent budget policy,
 - establishing procedures that minimize the inflationary impact of government regulations, and
 - indicating his intention to veto legislative measures and other actions of government that provide benefits to narrow special interest groups.
- o to break the upward spiral of costs and prices by
 - enunciating explicit numerical standards for noninflationary wage and prices increases, and
 - making clear his intention to use his administrative powers to support adherence to those standards in individual situations.

These measures indicate a recognition by the Administration that the government must take the lead in fighting inflation. Private cooperation with the pay and price standards could hardly be expected if the Federal Government were unwilling to set its own house in order. The steps we are taking are not just symbolic. The prudent budgetary policies we intend to pursue will create an overall climate in which market forces will work together with the pay and price standards to reduce inflation. And the actions we are taking in the regulatory area will help to moderate an important source of cost and price increases over the past 10 to 15 years.

Federal Budget Policies

The Administration is determined to pursue a stringent budgetary policy with respect to both spending and the budget deficit. The growth of spending must be strictly limited. As moderate and sustainable economic growth continues, the budget deficit must be reduced and eliminated.

In fiscal 1976, Federal expenditures represented 22-1/2 percent of the nation's GNP and the deficit was \$66 billion, an all-time record. Since then, the size of the deficit has been reduced substantially. In fiscal 1979, the deficit in the Federal budget will be less than \$40 billion. Next January, the Administration will submit its budget for fiscal 1980 -- the year beginning October 1, 1979. In the

context of an overall economy growing at a moderate rate, the President has set targets for planning the 1980 budget under which

- o the share of total spending in GNP will be reduced to about 21 percent of GNP -- a goal originally scheduled to be reached a year later -- and
- o the 1980 Federal budget deficit will be reduced to \$30 billion or less.

These goals will not be achieved without very difficult choices among competing demands on Federal resources. But a strict budgetary stance is utterly essential to success in the fight against inflation. We will demonstrate to business and labor that moderation in private wage and price decisions will not be frustrated by the pressure of excess demand.

In order to contribute toward these goals, the President has imposed severe limits on hiring of Federal employees for an indefinite period. Effective immediately, Federal agencies may fill only one out of two vacancies as they occur. This step will reduce the number of Federal employees budgeted for this fiscal year by about 20,000. In July the President announced a 5.5 percent limitation on Federal employee pay raises and a freeze on Federal executive pay levels.

In addition, the President has stated that he will oppose further reductions in Federal income taxes until we have convincing prospects for progress against inflation. The Administration is prepared to consider reductions in specific taxes that could contribute to fighting inflation, but only if those tax reductions are consistent with an overall framework of prudent budgetary policy.

Regulatory Policy

During the last decade we have expanded our efforts to protect the environment and the health and safety of workers and consumers. Clean air and water, a safe and healthy workplace, and protection for consumers against unhealthy and hazardous products are important national goals. But we must also recognize that their achievement has added appreciably to costs and hence to consumer prices. We must not abandon our goals, but we must attain them at a reasonable pace and without imposing unnecessary burdens.

With this principle in mind, the President has stated his intention personally to exercise his authority, as necessary, to ensure that the regulatory process is balanced and well managed, and that specific regulations with large economic impacts achieve their statutory goals at minimum economic costs and regulatory burden.

Efforts to reform the regulatory process have been underway since 1977. The President has directed regulatory agencies to prepare analyses of the effects of each proposed major new regulation. These analyses must identify the benefits and the costs of the proposed regulation and examine the implications of alternatives. An interagency review group has been established to review the most important of these proposals and to place comments on these proposals on the public record.

To strengthen further the government's effort to improve the regulatory process, the President has now taken additional steps:

- o The President has directed the formation of a Regulatory Council. The Council will include as members all Executive Branch departments and agencies with significant regulatory responsibilities. It would have the important task of coordinating duplicative or overlapping regulations. Douglas Costle, the Administrator of the Environmental Protection Agency, will chair the Council in its first year.
- o Most important, the Regulatory Council will develop a unified calendar of major regulations. The calendar would provide for the first time a comprehensive

list of regulations the Federal government is proposing, together with information on their cost, their objectives, and why they must be issued.

- o The President has directed each regulatory agency in the Executive Branch to include in its "sunset" reviews of existing regulations one or more regulations that have a major economic impact.

With the help of the Congress, progress already has been made in reducing the cost of existing economic regulations. In the past year, the Civil Aeronautics Board relaxed rules that controlled airline fares and allowed increased competition. The results have been lower air fares and record air passenger travel. The air deregulation bill just passed by the Congress is the first major deregulation effort in recent history. It will extend these benefits and make them permanent. Next year, the Administration plans to work with Congress to reduce regulation in other areas, such as surface transportation.

Strengthening the Dollar

Let me now turn to the most recent element in the President's anti-inflation program -- the actions, taken last Wednesday, to provide support to the dollar abroad.

These actions were fully described in the joint statement issued by Chairman Miller and Secretary Blumenthal, a copy of which is appended to this testimony.

It had become clear to officials both here and abroad that the recent steep depreciation of the dollar was completely unwarranted by fundamental factors. Rather, it reflected a self-fulfilling speculative momentum in exchange markets. This dollar depreciation was directly increasing inflationary pressures in the U.S. economy and thus threatening to undermine the President's anti-inflation program.

Moving to correct this situation before all elements of a fundamental attack on our economic problems were in place would have carried a grave risk of failure. But with an energy program enacted and a strong anti-inflation program announced, action to deal directly with the exchange value of the dollar became both feasible and necessary. And so, this week the President, in cooperation with the Federal Reserve and the governments and central banks of other countries, announced a series of strong measures to correct the excessive decline in the foreign exchange value of the dollar.

I would like to elaborate somewhat on three aspects of this decision:

First, the link between dollar depreciation and inflation.

While measurement and other difficulties make precise estimation difficult, econometric analysis of the United States economy suggests that the rate of inflation currently is at least one percentage point higher than it would have been if the dollar had not depreciated over the past twelve months. The inflationary pressures associated with that depreciation will continue to affect the economy into next year.

The causal relation between inflation and dollar depreciation runs both ways. The acceleration of inflation in our country has helped to drive the dollar down and this, in turn, has made the inflation worse. But excessive depreciation, not warranted by economic fundamentals, constitutes an independent source of inflationary pressure on the economy. It drives up import prices, and the prices of import-competing domestic goods, more than warranted by underlying considerations of cost and competitive position. Correcting the excessive depreciation of the dollar, not related to those underlying factors, therefore tends to remove an independent source of inflationary pressure.

Second, there is a solid basis for believing that the exchange markets had lost sight of economic fundamentals.

Careful analysis of our merchandise trade and current account

trends and prospects indicates that a substantial reduction of the U.S. current account deficit is now under way, and further improvement is likely to take place in 1979. Not only our internal forecasts, but independent forecasts by the OECD and other institutions are unanimous on this point. Some of this improvement is occurring because the U.S. growth rate is moderating while growth prospects for many of our important trading partners are improving. Moreover, the depreciation of the dollar, even before the latest movements, had been substantially out of line with the relative rates of inflation in the United States and other industrial countries. As a consequence, the competitive position of the United States in world markets had already improved markedly.

Third, the fundamental elements of a United States policy aimed at slowing inflation and sustained improvement in our international payments accounts are now in place: substantial reduction in the budget deficit, an effective energy program, an export promotion policy, and a comprehensive anti-inflation program.

It is not correct to argue that the government's actions to support the dollar increase the risks of substantial slowing of economic growth or recession next year, as some commentators have argued. On the contrary, these risks on balance have been reduced. Further decline in the dollar would have seriously threatened to undermine domestic

expansion. Stronger pressures on domestic interest rates would have developed. Furthermore, the erosion of purchasing power associated with higher prices of imports would have led to slower consumption expenditures. Finally, the turmoil in financial markets, the fall in stock prices associated with a continued decline in the dollar, and heightened uncertainty would have seriously undermined the prospects for further growth in investment spending. On balance, then, our government's actions on the dollar have reduced materially the risks of unacceptable economic performance next year.

Concluding Remarks

I am confident of the soundness of the Administration's anti-inflation program:

- o First, the program has been designed with a careful eye to avoiding the mistakes of the past. We have not set forth with a program that is bound to self-destruct before its basic purpose has been accomplished.
- o Second, the program recognizes that market forces and standards for wage and price behavior must reinforce one another.
- o Third, the program acknowledges candidly that government has itself been an important contributor to inflation and begins to take corrective action.

- o Fourth, the pay and price standards are fair and sensible, and the program contains a number of important incentives to encourage compliance by business and labor.
- o Fifth, and most importantly, success in reducing inflation will largely determine whether this Administration is able to move us closer to the achievement of our major national economic objectives. We are fully aware of that fact, and we will do whatever is necessary to make this program a success.