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Testimony by

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Inflation and Economic Opportunity

Mr. Chairman, Members of the Commission, I am pleased to be able to be here today to discuss some of the economic aspects of poverty and inequality in America. I would like to note at the outset that I am here as an individual and that my views do not necessarily reflect those of my colleagues on the Board of Governors of the Federal Reserve System.

In particular, I would like to address a widespread misconception about macroeconomic policy and economic opportunity. It is believed by many commentators that an aggressive and inflationary monetary and fiscal policy environment is helpful for promoting economic opportunity. The reason for this belief is two fold. First, money creation and the consequent inflation provide funds for the state while eroding the real value of privately held financial wealth. As financial wealth is relatively concentrated, this represents a highly progressive and redistributive form of taxation. Second, other things equal, inflation transfers real assets from creditors to debtors, effecting a private redistribution in addition to the one carried out directly by the state.

The data that I wish to present today suggests that whatever the merits of this reasoning in theory, it has not worked in practice. Rather than massive quantities of fiscal or monetary stimulus, I believe that carefully targeted, incentive oriented, policies are crucial to advancing economic opportunity for all Americans. While for data reasons, the emphasis of my comments

will be on evaluating the economic standing of African Americans, I believe that my conclusions are probably applicable to other relatively disadvantaged ethnic and racial groups as well as to individual Americans seeking economic opportunity.

The U.S. economy is now in the early stages of the third business cycle we have experienced in the last two decades. The first two of these business cycles were marked by very different sets of monetary and fiscal policies and very different inflation scenarios. As such, a comparison of the two can provide useful evidence for evaluating the proposition that inflationary policies are useful in promoting economic opportunity. The first cycle ran from the 1973 peak to the 1981 peak, the second from 1981 to 1990. I believe that it is important to use peak-to-peak analysis in order to control for the effects of the business cycle in determining levels of household income. While it is true that the precise timing of business cycles is on a quarter to quarter, or even month to month basis, the detailed data on household income and poverty rates are collected on an annual basis. Hence my choice of the years 1973, 1981, and 1990 for analytic purposes.

The 1973-1981 business cycle was marked by an aggressive fiscal and monetary policy posture which led to an increase in the year-over-year inflation rate from 6.2 percent to 10.3 percent. Not only was inflation accelerating over this period, it also maintained a relatively high average rate of more than 10 percent. By contrast, the 1981-1990 cycle saw a deceleration in

inflation from 10.3 percent to 5.4 percent, with an average rate of less than 5 percent. Certainly these two periods should provide a test of the hypothesis that inflationary policies are good for opportunity and income distribution.

The data suggest that this is probably not the case. Table 1 shows the distribution of incomes of African American families in 1973, 1981, and 1990. The income levels have been adjusted for inflation over this period and reflect 1990 price levels. During the 1973-81 period little progress was made, on average, by black American families. The real median income of all black families fell nearly 11 percent, far more than the 8.8 percent decline for white families. Most troubling was a sharp rise in the number of families with real incomes under \$10,000, although the deterioration in black family income was indicated among all income groups.

By contrast, the 1981-90 period saw a rise in median black family income of 12.3 percent, compared to a 9.2 percent rise in white median family income. Most striking in this period was the sharp rise in the proportion of black families with incomes over \$50,000. I think these data illustrate that significant gains were made by many African Americans over the past decade as a significant black middle class emerged. Although this period was generally positive, I do find it troubling that more gains were not made by the lowest income group. Although this group expanded greatly during the 1970s, it failed to contract significantly during the 1980s.

One important adjustment to looking at income data is the role of family size. Table 2 presents the income of African American families in various quintiles relative to the poverty threshold for a family of that size. In the top three quintiles, the data indicate a relatively stable income-to-poverty threshold pattern during the 1973-81 period followed by a significant increase during the 1981-90 period. It should also be noted that black families in these income ranges made significantly greater income gains than white families earning the same income levels.

However, the fourth quintile of black families showed relatively little change in their income position while the bottom quintile showed a continuing decline in its income level. It should be noted that these income data exclude in-kind transfer payments which rose over this period. But; the troubling fact remains that cash income for those black families who were least well off continued to deteriorate. A clear dichotomy exists between the quite favorable performance of the top three fifths of black families and the much less favorable performance of other black families.

The third chart shows the impact of this on the distribution of income among black Americans. Between 1973 and 1990, the top quintile of black families saw their share of total black family income rise 3.3 percentage points while the bottom two quintiles saw their share decline by 3.8 percentage points. Black family income today is less equally distributed than it was in 1973 and is less equally distributed than is white family income.







I believe that all three charts document both the success stories of the last decade and the challenges ahead of us in the 1990s. Most important, they show that inflationary policies do not correspond with enhanced economic opportunity. In fact, lower inflation helps to advance one of the very important measures of economic opportunity in America: home ownership. The fact is: lower inflation and interest rates greatly increase the affordability of housing in America. The National Association of Realtors puts out a housing affordability index. Today, by this measure, housing is more affordable to the typical family than at any time since 1976. If one uses a slightly more complicated statistic that adjusts for housing quality, the favorable affordability comparison dates back to 1973. That is particularly good news for those families seeking to get their feet firmly planted on the ladder of economic opportunity and those entering the middle class. In this regard, the lower inflation of the 1980s, and the correspondingly lower level of interest rates was probably of tremendous assistance to those top two or three quintiles of African American families who experienced such a favorable income performance.

Let me be clear on why lower inflation assists home ownership. Higher inflation and interest rates impose a form of forced saving on homebuyers. They must pay an inflation premium in their mortgage payment which is offset by a rise in the nominal value of their home. Lower inflation lowers this forced saving component. A lower cash flow is needed to finance an

identical house as a result. While the change may not lower the long-term net benefits of homeownership, it does allow more people to afford their own home.

Our challenge today is to reach those who were not able to advance in the past. This Commission will be considering how to meet this challenge in the future. I believe that we need incentive oriented programs -- lower effective rates of taxation, lower hurdles to owning one's own business, and greater opportunities for homeownership. Each of these is targeted on individual initiative and attainment, which I believe is the key to success. What would be inappropriate in my view is a return to the inflationary policies of the 1970s. I believe that such a return would not only be ineffective, it might actually create new barriers to economic progress for those who need it the most.

Table 1
LEVELS OF REAL BLACK FAMILY INCOMES
 1973, 1981, 1990

| INCOME (1990 Dollars) | 1973 | 1981 | 1990 |
|--|--|--|-------------|
| OVER \$50,000 | 10.4% | 10.2% | 14.5% |
| |  0.2% |  4.3% | |
| \$25,000 - \$50,000 | 31.4% | 28.7% | 29.1% |
| |  2.9% |  4.7% | |
| \$10,000 - \$25,000 | 37.8% | 35.0% | 30.8% |
| |  5.6% |  0.5% | |
| UNDER \$10,000 | 20.5% | 26.1% | 25.6% |

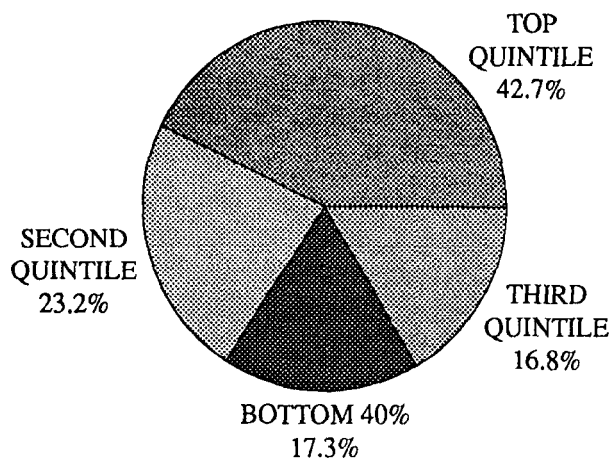
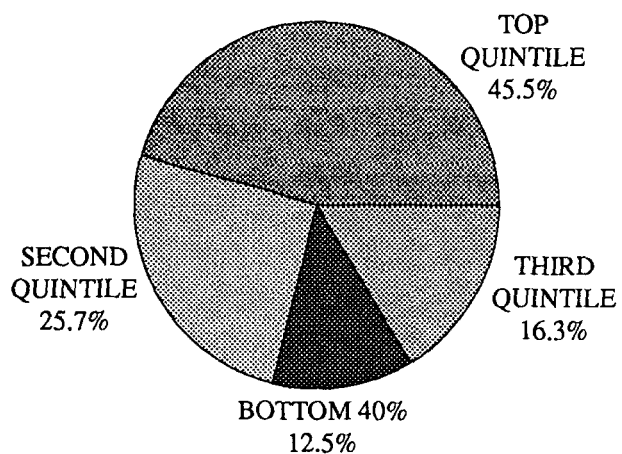
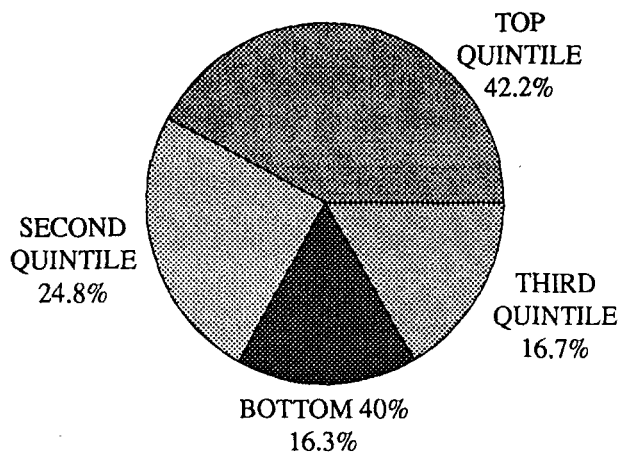
Source: U.S. Bureau of Census; Current Population Reports, Series P-60, 1990.

Table 2
INCOME TO POVERTY RATIOS FOR BLACK FAMILIES
 1973, 1981, 1990

| QUINTILE | 1973 | 1981 | 1990 |
|----------|------|------|------|
| TOP | 4.49 | 4.31 | 5.53 |
| SECOND | 2.64 | 2.62 | 3.12 |
| THIRD | 1.78 | 1.73 | 1.98 |
| FOURTH | 1.14 | 1.05 | 1.10 |
| BOTTOM | 0.59 | 0.47 | 0.42 |

Source: U.S. Bureau of Census; Current Population Reports, Series P-60, 1990.

Table 3
DISTRIBUTION OF FAMILY INCOMES
 (Adjusted for Family Size)



Source: U.S. Bureau of Census; Current Population Reports, Series P-60, 1990.