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IS INFLATION LICKED?

Remarks by

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before the

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I am pleased to have the opportunity to speak to you today. I always think of the Boston Fed as being distinct for the way in which it has successfully blended its national responsibilities and its regional identity. Down through the years, the Boston Fed has maintained an active involvement in the economic issues confronting the New England region as it has moved beyond the period of regional stagnation in the 1970s to the more recent period of sustained growth. I also know, from personal experience, of the valuable contribution that President Morris and the directors of the Bank have made to national economic policy.

The issue I would like to talk about today is inflation. Compared with the situation that existed at the end of the 1970s, we obviously have come a long way toward bringing inflation under control. Indeed, the most recent data show the CPI actually falling. In addition, wage inflation, which has moderated substantially over the last few years, seems to be slowing still further, and commodity prices are generally depressed. The critical question is: Do these events indicate that the problem of inflation is now behind us--or soon will be--so that economic policy can be safely tilted more in the direction of achieving a high rate of real growth? In short, is inflation licked?

In working toward an answer to this question, I would first like to review the events of the past few years. I will then take a closer look at the recent economic developments.

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Finally, I will explore some of the major influences that seem likely to shape the prospects for inflation in the future.

Many of you are familiar with the rise and fall of inflation over the past couple of decades, and I do not intend to take you through every twist and turn of the major price indexes. Instead, I want to make some general observations about our collective experience with inflation, focusing on the period that began around 1979.

By 1979, price inflation had accelerated to double-digit rates, and surging price expectations were beginning to permeate the decision-making processes of households and businesses alike. Confidence in the dollar was ebbing in international markets, and, at home, the credibility of monetary policy--and of economic policy in general--was beginning to erode. A feeling was growing that the government would not, or could not, take the necessary steps to bring inflation under control. The task of policy was to re-establish that lost credibility.

The Federal Reserve, of course, played a central role in restoring the credibility of national economic policy. The Fed had to make it clear, in a way that a skeptical public could readily understand, that the inflation situation was going to be turned around. Expectations that had become deeply entrenched needed to be uprooted.

In the event, turning inflation around proved to be a painful and costly process. Interest rates soared. One

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recession occurred in early 1980, and after a brief recovery, a second recession in 1981 and 1982 pushed unemployment rates to the highest levels of the postwar period.

Prices, however, did decelerate sharply. From 1980 to 1982, the rate of increase in the GNP implicit price deflator was halved--from around 10 percent to just over 5 percent. The slowdown in consumer prices was even more dramatic--from 12-1/2 percent in 1980 to 4-1/2 percent in 1982. Wage increases, which had remained large during 1981, also started to moderate by the end of 1982. Wage price interactions--which had helped to maintain the momentum of inflation in the 1970s--thus began to work in a more beneficial direction. Smaller wage increases eased the pressures on businesses to raise prices, and, in turn, the slower rate of price increase relieved the pressures on workers to catch up with past inflation or stay ahead of anticipated inflation. As these processes unfolded, the momentum of inflation started to be replaced by some momentum toward disinflation.

The next chapter in the inflation story began with the start of the economic upturn and has extended until roughly the present. This period was largely one of consolidation--of building upon earlier gains. The task of policy in the 1979-82 period had been to break the momentum of inflation. The task now became that of keeping inflation down during an economic

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recovery. The historical record on this score was not encouraging. During the 1970s, inflation slowed during recessions, only to surge back to even higher levels in the subsequent expansions.

Inflation expectations still remained high after the 1982 recession. The public had experienced too long a period of worsening inflation to fully believe that we were now, once and for all, on the path to lower inflation. Expectations also began to be influenced to an increasing degree by growing federal budget deficits, which made many observers suspect, rightly or wrongly, that the government would eventually turn to monetary expansion as a way to assist in financing its deficits.

This set of considerations required policy-makers to tread softly. Policy needed to support the nascent expansion, but, at the same time, avoid pushing the economy ahead so fast as to risk reigniting the inflationary fires that were now being damped. All in all, I think it is fair to say that we have succeeded reasonably well in walking that narrow path between too much growth and too little growth. In its early stages, the expansion was more robust than expected and unemployment rates dropped sharply from their recession highs. Although growth has slowed during the past two years, job creation has remained substantial, and, apart from some short-term variation, unemployment rates have edged down further.

The nation's price performance also remained favorable. Inflation did not accelerate as it had in some other expansions,

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even as unemployment was dropping. Indeed, in 1985, the third year of the expansion, most inflation measures rose at about a 3 to 4 percent rate--little different from their rates of increase at the beginning of the recovery. This year, with the collapse in crude oil prices, it appears that inflation probably will slow still further.

These favorable price developments resulted not only from the economic policies that were followed, but also from some special factors. After peaking in 1981, oil prices began a long period of decline that ended in the extraordinary rapid decline that we saw in early 1986. Similarly, in the agricultural sector, the excess demand pressures of the 1970s gave way to a situation of excess supply that has persisted to the present.

Developments in international markets also helped to reinforce the disinflationary process. The foreign exchange value of the dollar began to appreciate in late 1980, and with only a few temporary pauses, maintained an upward course for more than four years. At its peak, the value of the dollar, relative to other major currencies, was more than 80 percent above its previous trough.

This prolonged appreciation of the dollar had profound impacts on U.S. price and wage behavior. Import prices stabilized, and U.S. businesses were forced to exercise price restraint in order to remain competitive with foreign producers. In addition,

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the pressure of foreign competition weighed heavily on labor markets, further reinforcing the trend toward wage moderation.

The rise of the dollar, the drop in oil prices, and an excess supply situation in agriculture and other commodity markets created an unusually favorable environment for holding inflation in check in the first half of the 1980s. My concern as we look ahead is that some of these factors are not likely to be as favorable as they have been in the past three and a half years. Policy-makers therefore are likely to confront a new, and in many respects, still more challenging environment.

The precise nature of the challenges that lay ahead are likely to be determined to a great extent by several international and domestic developments that currently are combining to reshape the economic landscape. Let us consider these developments in turn. First, as I mentioned earlier, world oil prices have plunged since the start of the year, to about half the levels of a year ago. Second, the dollar has come down substantially from its peak of early 1985. Third, there are hopeful signs that Congress and the Administration may finally take the actions necessary to reduce the federal budget deficit. Fourth, long-term interest rates have moved down considerably since last fall, apparently reflecting both an easing of real rates and some shift toward lower expectations about future inflation.

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Sorting out the implications of these developments for economic activity and inflation is not easy, but let me try to identify some of the more important effects. The drop in oil prices obviously is currently exerting strong downward pressures on the rate of inflation. However, these downward pressures will probably dissipate as the oil price declines come to an end. Put simply, oil prices probably are going to hold down inflation this year; later on, they seem likely to have a more neutral effect--or perhaps even an upward effect if there is a sustained surge in petroleum demand.

Thus far, the fall in the dollar, in contrast to oil, has not had a very visible impact on U.S. inflation rates. Although the prices of imported goods have begun rising--and at an accelerated pace in recent months--not much of the rise, as yet, appears to have been passed on to consumers. Over time, however, I suspect that these dollar effects will become more visible and that, in terms of their long-run impact, they may prove to be more important than the changes that we have seen in oil prices. Indeed, the prospect of a sustained rise in import prices is a major factor that makes me hesitant to claim a lasting victory over inflation at this time.

We also will need to be alert in the months ahead to some of the <u>indirect</u> effects of falling oil prices and a depreciating dollar. In particular, falling oil prices, by boosting

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the real purchasing power of consumers, should eventually have a stimulative effect on aggregate economic activity, although some regions of the country--notably the Southwest--are being hurt. Similarly, the drop in the dollar, by fostering increased exports and damping import growth, should eventually prove expansionary. These potentially-stimulative developments, together with the recent declines in long-term interest rates, raise the possibility of a substantial pickup in real activity. And, while a temporary upswing in growth probably would not lead to a serious pickup in inflation, a sustained surge in activity might very well lead to enough tightening of labor and product markets to generate renewed inflationary pressures.

I recognize that, for the time-being, these concerns seem only hypothetical and that, with the unemployment rate hovering around the 7 percent mark and factories operating at less than 80 percent of capacity, we currently have some room to expand. However, I also recall from the 1970s how quickly a situation of seemingly excess capacity in labor and product markets was transformed into a situation of excess demand for resources. Perhaps, as some would argue, the unemployment rate at which inflationary pressures begin to build is edging downward. But, as a practical matter, we cannot be certain exactly where that inflationary threshhold lies, and the prudent policy would seem to be that of remaining wary, lest renewed inflationary pressures emerge sooner than expected.

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I would feel more comfortable about our potential to expand at a rapid pace in the period ahead if there were evidence that the long-awaited acceleration in productivity growth were at hand. In reality, however, productivity growth has been disappointing in this expansion. Over the past year, for example, there has been no productivity growth in the nonfarm business sector; and, abstracting from cyclical swings, the overall productivity performance during this expansion looks only slightly better than the lackluster trend of the 1970s.

You probably have gathered by now that I have some real doubts about whether we have, in fact, licked inflation once and for all. I don't think that we have. Indeed, when one factors the oil price effects out of the recent CPI data, it appears to me that the underlying inflation rate still is in the 3 to 4 percent range--with a risk that the numbers could start coming in higher when the effects of rising import prices start to become more pronounced.

I do not want to leave you, however, with the impression that all is lost. Over time, oil prices are going to go up and down, as is the exchange value of the dollar, and inflation rates will fluctuate as these adjustments occur. But a rise in oil prices or in import prices in general need not have the destructive longer-run consequences that similar adjustments had in the 1970s. Imports, for example, are only about 12 percent of all domestic spending, even with the import surge of recent

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years. Hence, even a fairly sizable one-time adjustment in import prices, by itself, would not necessarily be a critical setback for our anti-inflation efforts.

Serious difficulties would arise, however, if the increase in import prices started getting built into the domestic economy through wage-price interactions or through expectational effects. Avoiding these destructive second-round effects probably is the key ingredient in determining how good--or how bad--our domestic inflation performance will be over the next several years.

I am reasonably hopeful that these destructive second-round effects can be minimized. Surely, many of our workers and businesses now recognize that they are competing in world markets and that it is in their long-run interest to keep wages and prices at competitive levels, rather than ratcheting up in step with rising import prices. And, to the extent that restraint prevails in the private sector, monetary policy can be more effective in promoting economic growth while at the same time maintaining the long-run commitment to price stability. Even if all goes well, however, it seems to me that there is considerable potential for a moderate pickup in inflation over the next year or so.

Thus, while I am not pessimistic about our future prospects, I am not as optimistic as some; and my final answer to the question "Is Inflation Licked?" must be "No, I don't think

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so." Apart from energy, actual inflation rates still are in a range that, only a decade and a half ago, were viewed as being so intolerable that they led to a program of extensive wage and price controls. Nor would anyone contend that inflation expectations have adjusted down to zero.

Perhaps, however, the question should be changed to "Can Inflation Be Licked?" and in this case my answer would be "Yes, but only if we have the will."

Our collective will may be tested in the period ahead, with new dangers that could place new demands on both the private sector and government policy-makers. I would hope that we can be skillful in meeting those demands. As one who joined the Federal Reserve Board in the late 1970s, when the crest of inflation still was rising, I am aware of the great difficulties--and the considerable costs--of gaining control of inflationary pressures once they have been unleashed. That experience suggests to me that a degree of caution is appropriate at the present time, both in assessing our past gains against inflation and in formulating our future economic policies.

In particular, we should not, through our own policies, create a situation in which a run of bad luck, such as we experienced in the 1970s, can do serious long-run damage to the economy. We live in a world in which future events are not highly predictable and in which the "fine-tuning" of economic policy is not possible. In such circumstances, there seems some value in

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maintaining an appropriate margin for error, in the event that the future does not unfold as benignly as we might like.

We have made substantial progress against inflation since 1979. The recent data, especially, have been highly favorable. But, at the same time, nothing could be more hazardous, in my view, than to suppose that our problems with inflation are behind us once and for all.

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