FOR Release on Delivery
Friday, April 19, 1974
12:00 Noon, CDT

THE FEDERAL RESERVE AND INFLATION

Remarks of

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before the

Chamber of Commerce

Lexington, Kentucky

April 19, 1974

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THE FEDERAL RESERVE AND INFLATION

I want to talk to you today about the primary problem before the country and before the world -- inflation. It is of primary concern because, more than any other economic consideration, it is a force that can permanently warp the life of each of us -- the poor even more than the rich. And, more surely than anything else I know of, it can alter the destiny of nations, the great no less than the small.

I want to emphasize my feeling that inflation is the enemy we must currently deal with, and my determination to deal with it, because unless we do so, every other battle will be lost. That includes the battle for high employment, for a higher general standard of living, and for a healthy and growing world economy that has resources to spend on assisting disadvantaged nations to a higher economic level.

Consequently, the fight against inflation is a problem on which the Federal Reserve is hard at work, and I want today to give you what I hope will be a better sense of the nature and dimensions of the problem. Before I do so, however, let me mention a little known aspect of our role in trying to bring inflation under control. This is the fact that one of our functions -- and we are well aware of it -- is to serve as a resiliant whipping post. In the relatively brief time that I have been a Member of the Federal Reserve Board, I have learned that we are not only the object of some people's criticism some of the time, but that we are also the object of almost all the people's criticism some times. Recognizing ourselves, therefore, as performing the important social function of repository of last resort for the anger and frustrations of the nation over the fact that

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everything never goes right for everyone, and sometimes nothing seems to go right for anyone, it is our policy to be patient, to look ahead as far as we feel we can trust the data, and do our pragmatic best, as we are given to see it, for the economy as a whole. We examine all criticism and try to make use of all the constructive parts. The rest we absorb, as an institutional duty.

One of the greatest difficulties of monetary policy making is that it takes effect with lags that vary from a few months to many months. That would, of course, be no problem at all if we only had a cloudless crystal ball, but such is not a part of the equipment of our board room. Even so, the problem of the long drawn out effects of monetary policy decisions would not be as troublesome as it sometimes is if we, in fact, had the precise degree of control over the economic climate that is often attributed to us. The fact is that we have neither the informational base, nor an exclusive ability to influence the economy. Thus, things often do not work out as we hope, and looking back over the long term, it is clear that we must share in the blame, even if we cannot accept the full responsibility some of our critics would heap upon us, for inflationary trends.

But one of the things I want to emphasize -- not in a spirit of exculpation or of shifting responsibility, but as a contribution to realistic dialogue on this subject -- is that there are fundamental factors affecting the inflation equation which are controlling and about which the Federal Reserve can do little.

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There is no
Free Lunch

One of the most important of these factors is the tendency of wage rates continually and generally to exceed overall productivity gains. The net is inflation.

Since we have not undertaken an effective national program to upgrade productivity, the result of excessive wage increases has been a built-in inflationary cost-push bias. The desire on the part of workers for more income comes not only from the union worker but also non-union employees in both the public and private sector. Furthermore, many wage contracts, and even our retirement programs, are beginning to include cost-of-living escalators. Take, for example, the Civil Service plan. That plan carries a cost-of-living escalator and a similar notion will be added to social security benefits beginning in 1974.

If private and public policies are such as to lead to increases in wage rates faster, over time, than we increase productivity, there is no practical alternative but an inflationary trend. If the central bank were to refuse to finance pressures on prices resulting from rising costs there would inevitably be a slow down in economic activity, and a rising level of unemployment.

The most recent inflationary wave has, of course, been due primarily to sharply rising food and energy prices. The ramifications of the recent energy price rise are pervasive throughout the American economy and are showing up in the cost of plastics, electric power and the like. These two elements account for perhaps 75 per cent of the inflation of the past twelve months. Should the central bank control

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the growth of money so tightly that as these prices go up other prices go down?

Perhaps the question can best be posed this way: If every city, village and town in this country were to raise a sales tax of 3 per cent effective immediately, should the central bank move to offset the price increases resulting from that tax increase?

No Quick Cure

The inflation we are suffering has had a relatively long history -- statisticians trace it to about 1963 when the wholesale price index began rising. It is thus a deep rooted problem which cannot be quickly cured.

To quickly cure the current inflation, the central bank could shrink the money supply dramatically. But we would have to take substantial responsibility for what would shortly result -- heavy unemployment.

The path to reduction, perhaps eventual elimination, of inflationary pressures is a long one. It is certainly bordered on one side by responsible monetary policy. But on the other side there must be containing forces of equal strength made up of responsible private wage and price behavior, and responsible spending and taxing behavior by all governments, from townships to the Federal Government.

The Emphasis on Unemployment

The question is not whether we should accept unemployment or inflation. The question is what policies yield the least unemployment and the best price stability. Further, the question includes the fact that

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high continued inflation leads to high levels of unemployment, and to price rises that impose a regressive tax.

In recent years policymakers and Congressmen have given much more attention to problems of unemployment than to the problem of stable prices. The Employment Act of 1946 has been a compelling piece of legislation. It is recognized that extended unemployment means that the economy will be producing below its potential and that, consequently, long-run growth will be reduced. Thus, in the past decade or more inflationary restraint has invariably been given second billing to the overriding goal of high employment.

However, the costs of inflation are also quite high. Rising prices reduce the purchasing power of people on fixed incomes or whose incomes are slow to adjust to price changes. This reduction in real income hits particularly on those who are living on saved money. It is easy to overlook the fact that consumers are the nation's creditors while governments and corporations are the debtors. Holdings of liquid assets, combined with equity in life insurance policies and retirement funds exceed the indebtedness of every income group of our population. The same is true of every occupational group and every age group except the newly marrieds. Increases in the price level, therefore, robs the great masses of our people and tends to impoverish those who lack the knowledge or the means for a proper defense against inflation.

There is another and even more severe consequence of inflation. It undermines confidence in our system. Our vast economy is built on paper claims against dollars. There is a clear danger that people will avoid paper claims and move toward 'real' things such as gold at $170 an ounce.

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If prosperity is to flourish, people must have confidence in their own economic future and that of their country.

Thus, there is a pressing need in the country to revise the Employment Act of 1946 to emphasize that while full employment is -- and remains, let me stress -- a national objective, it is an objective that fulfills its promise only at reasonably stable prices. Or perhaps better, we need at this juncture a separate and simple piece of national legislation. At the least, we need a national declaration of purpose with regard to the level of prices, a declaration intended by Congress to have the moral force such as the Employment Act of 1946 exercises with regard to the level of employment.

As the economy has turned down in recent times, the Congressional Committees began hearings on what action should be taken to stimulate economic activity so as to preclude higher levels of unemployment. Indeed, the majority on a key Congressional Committee recently reported the need for an additional fiscal stimulus this year of some $10 billion.

Policies to reduce unemployment generally include stimulating aggregate demand -- an increase in deficit spending has been a primary tool of fiscal policy. In the past five years there has been an expenditure at the Federal Government level of some $60 billion more than the Government has received in tax revenue. But the foregoing figure is merely that included in the unified budget. When all spending at the Federal level is included, the figure is closer to $120 billion of deficit financing by the Federal Government in recent years. Once again, let me remind you that it is not within the power -- and certainly not within the moral right, as I see it -- of the Federal Reserve to set itself up to defeat Congressional intent. We

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can, as Chairman Burns does constantly, implore the Congress to move to a non-inflationary spending basis.

The Bleak History
of Government Spending

In 1929, expenditures by all Government, at all levels in our country, totaled about 11 per cent of our Gross National Product. In recent years, this total has been about 1/3 so that Government expenditures as a percentage of our GNP have about tripled since 1929.

At the Federal level in recent years, growth in expenditures has been startling. For example, the fiscal 1975 budget proposed by the Administration is an increase of 12 per cent over fiscal 1974 which was an 8 per cent increase over 1973. With the real economy growing at about 4 per cent per year on average in recent years, and the dramatic size of Government spending totals, we must question the inevitable annual dramatic increases in Government spending.

One of the primary fuels to the inflation fire, then is excessive Government spending financed with Government deficits. If taxes cannot be increased so that receipts equal expenditures, then expenditures must be cut. There are many, many worthy projects of pressing priority. But all worthy projects cannot be done now. Some of them must be put off for later years.

Our Government just like our families must set spending priorities. And it is heartening that the U. S. Congress is currently in the process of enacting a landmark piece of legislation which will create a joint committee on the budget. This piece of legislation is no doubt one of the two or three most important pieces of legislation in our lifetimes. And we should salute the Congress for this achievement.

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The Role of
Private Power

Thus, it is clear to me that despite the assertions by some that you may have heard -- that only the central bank creates inflation -- Governmental spending and taxation policies play a major role. So also do large corporations and large labor unions. There is no gainsaying the active competition of major corporations in the marketplace. But today it more often takes the form of services performed or quality of products. Price competition is much less popular.

There are obvious elements of monopoly in labor markets, which tends to make for large wage increases bearing no relation to productivity gains.

When it is suggested that the old economic rules have not been working as they should, one need look no further than American steel production for an explanation. Employers accede to union demands because they feel helpless, and also because they know that their American competitors must foot the same wage bill and partly because they are able to pass the wage increase along in the form of price increases to their customers.

So there you have it. Some, if not many, suggest the following: Workmen throughout the country can demand and get wage increases that bear no relation to productivity gains. Government can spend $120 billion more than it receives in five years. Corporations can escalate their prices. Oil producing countries can create a cartel, limit production at will and triple or quadruple the price of oil. There can be a five year drought in West Africa and the world food supply can be seriously affected

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by such events as the disappearance for a time of the anchovy crop off the coast of Peru. All this may be made worse by the fact that the Russians simultaneously experience poor crops. Soybeans can rise from $3.50 a bushel to a peak of $12.00 and hold there for a time. None of this -- according to some critics of the Federal Reserve -- will basically affect inflation. Just let the Federal Reserve Board have the courage to put the economy through the wringer and inflation will evaporate.

Of course, we cannot put the economy through a wringer. To me, such a simple notion overstates the central bank's role. Inflation, our key problem, is everyone's problem, and each must share the burden of working out a solution.

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