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# APPROPRIATE MONETARY AND FISCAL

# POLICIES ARE NOT ENOUGH

Remarks by

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# APPROPRIATE MONETARY AND FISCAL POLICIES ARE NOT ENOUGH

This nation today is living through a crisis for which an obvious and near term solution is not evident. The problem is inflation -- an old and recurrent one for the U.S. -- but never in my lifetime has inflation been as protracted or severe as now. The critical nature of our current problem is evidenced by consumer prices rising at about 12.1 per cent at an annual rate over the year, and prices at the wholesale level having jumped a staggering 20 per cent during the same period.

The consequences are readily apparent throughout the economy today. Inflation has had a debilitating effect on the purchasing power of consumers, on their savings and other financial assets, on the efficiency of our business firms, on the conditions of financial markets, and on public confidence -- the keystone of economic progress. Therefore, I think that it is important to understand the nature of the problem confronting the nation if adequate solutions are to be developed.

This current inflation differs from previous experience in a number of respects. Although inflation originated from conditions of excess demand in the mid to late 1960's, we continue to experience severe price pressures despite a gradual but extended decline in economic activity. That is, we now suffer from severe inflation rate problems which are compounded by a recession which may deepen. Real output has now declined for three consecutive quarters.

This is thus a markedly different environment than any the nation has experienced in recent history. Not only is the current inflation quite intense, it is also of relatively long duration so that it has tended to create its own momentum, fed by inflationary expectations among consumers, workers, and businessmen. In this context, I suggest that traditional monetary policy tools must be supplemented by other actions to effectively combat cost-push inflation while at the same time avoiding a protracted recession. A number of policy scenarios have recently been advanced culminating in the President's proposed economic package which calls for some overall restraint with a number of selective measures to aid certain sectors and groups in the economy. While I support the Administration's economic package, it does not go far enough to win this inflation battle. Consequently, I would like to discuss with you briefly today the nature of the problem as I perceive it.

## Anatomy of the Current Inflation

The roots of our present inflation problem can be traced to the mid-sixties when the demands of the Vietnam War -- financed largely by deficit spending -- combined with a strong business expansion and the costs of 'Great Society' programs to produce an overheated economy. Our large scale active Vietnam involvement began in 1965. In that year, prices* rose by less than 2 per cent. But by 1968, this price index was increasing at a rate of more than 4 per cent. Demand pressures subsided with the advent of a recession at the end of 1969 when unemployment rose substantially.

* As measured by the GNP deflator, the broadest overall measure of price behavior.

However, inflation did not decelerate during the slowdown. Wages and other costs continued to rise rapidly and pushed prices up further. Between 1965 and 1970, Federal Government expenditures increased from $118 billion to $197 billion, an increase of 66 per cent. To curb the wage-price spiral, controls were introduced in August 1971 and the inflation rate was temporarily reduced. However, the momentum of wage and price increases picked up sharply in 1973 as a result of a number of factors. These included the relaxation of controls -- necessary as that was -- as well as the consequence of a world-wide boom in economic activity which produced pressures on capacity in a number of key industries.

Special
Factors

During the past two years, the general price level has been adversely affected by several special factors. The most prominent, of course, has been the behavior of food and fuel prices. Together they have been responsible for a major share of the increase in consumer prices over the past year. The rise in food prices felt by consumers reflected even more pronounced increases at the wholesale level in farm prices for feed. These, in turn, stemmed from an extraordinary surge in world grain prices in 1973 as disappointing harvests coincided with a surge in world-wide demand for our food and feedstuff. Higher prices of grains and soybeans together with the disappearance of the Peruvian anchovies -- which as you undoubtedly know form a significant share of animal feeds -- forced meat prices up and curtailed supplies.

Adding to the inflation problem the oil embargo and the sharp oil price rise dictated by the producing countries' capital led to a four-fold increase in the cost of oil products.

And there were other sources of inflationary behavior, not often cited. The devaluation of the dollar and the subsequent floating of exchange rates depreciated our currency about 16 per cent against the world's other currencies. This initially increased the dollar price of imports more than it decreased their volume, adding to price pressures. Additionally, the dollar depreciation made our exports more attractive in world markets, and increased foreign demands for our products, aggravating shortages and putting further pressure on prices.

## The Outlook

The recent record of price inflation has been abominable. But the more important issue is: what are prices going to do in the future? I have no crystal ball, but I think some valid observations can be made.

First, it is clear that monetary policy has had some effect recently in curbing excess demand. We should have no demand-pull inflation in the immediately foreseeable future. Although there are still some shortages of materials, shortages appear to be rapidly disappearing. Also some of the special factors cited above as exacerbating our recent inflationary problems are one-time adjustments which should not be a continuing source of price inflation. The effect of decontrol and devaluation is now history. It is likely that we still face increased food prices, the extent of which I would be unwilling to estimate. Without an evident will, so far, to practice the necessary conservation, we appear to be at the mercy of the oil cartel with regard to energy prices. It can be said, however, that, while some of the impact of past oil price increases have yet to work their way through the economy, rates of increase comparable to those of the past year appear unlikely.

Setting the special factors aside, I cannot forecast that responsible fiscal -- if achieved -- and monetary policies will cure the inflation. These are necessary but not sufficient conditions. Given free and flexible markets, they would be quite adequate. But too many of our product and labor markets are _not_ free and flexible.

I do not think that we can expect the intense price inflation to moderate quickly. There are several reasons why the traditional counter-inflationary policies are not likely to work well in the immediate future. First, we face a situation in which all sectors of the economy are, not surprisingly, attempting to defend themselves againt the corrosive impact of inflation. The instrument of their defense is market power. The result of such behavior within the economy is to intensify inflation. The desire of any group to maintain its real income in the face of rising prices is quite understandable. The rub is that, if real output is falling and if significant wealth is being transferred abroad -- as is the case with rising oil prices -- clearly not everybody can maintain his or her real income. The ones who are and will be successful are those who have the most effective control over the prices for which they sell their goods and services -- in other words those who have market power. I should stress that everybody is not so fortunate: those with power will maintain their real incomes by increasing their prices (or 'wages') and the resulting inflation will further decrease the real incomes of those people who lack such power. And this tends to aggravate inflation.

Thus, the economy has moved into a new phase of the continuing inflation: an income-cost-push period. The starring roles in this phase are being played by those firms which use noncompetitive pricing policies and those workers who can obtain inflationary wage increases despite the weakness of the labor market.

Wage-push pressure on prices is one key cause of the continuing inflation, perhaps the dominant cause. That is, the primary impetus of the inflation during the past 12-18 months has been 'special factors'. But the economy has now moved into a wage-push inflation era again. It results when wage gains exceed productivity increases. Since World War II, compensation per manhour in the private nonfarm sector has increased at an average annual rate of 5.4 per cent while output per manhour rose by 2.5 per cent. Over the past year, wages have risen by nearly 9 per cent while output per manhour <u>fell</u> by more than 2 per cent. The prospects throughout 1975 would seem to be for little moderation of wage increases and continued depressed productivity -- a certain recipe for rapid price inflation.

The central question is, then, why does the American economy have this inflationary bias in its wage-setting process? There are two reasons for which wages exceed productivity:

> <u>A scarcity of labor</u>. The bargaining effectiveness of workers is generally enhanced when this condition exists since labor scarcity typically accompanies a

high level of aggregate demand when firms feel that increases in labor costs can be passed through to the consumer.

An exercise of monopolistic labor power through the collective bargaining process. This occurs when well situated workers are able to negotiate large wage increases regardless of the state of the labor market.

Since there is little prospect of any generalized excess demand for labor over the near term, the immediate problem of continued price inflation is the exercise of labor's massive market power. And increasingly, substantial segments of the labor force are able effectively to use such power. Many industrial unions, for example, can increase costs to an entire industry and expect, even in competitive industries, that these increased costs will be passed through to consumers in the form of higher prices.

I should emphasize, however, that not all unions possess such market power nor is such power held and exercised only by unions. Many non-unionized firms which possess product-market power give their employees inflationary wage increases, especially in a period of rising prices, because they feel that their workers should not bear the brunt of falling real wages. Faced with falling morale and productivity and a possible union organization drive, some firms would rather grant the wage increases and pass their costs through to the consumer. Such inflationary wage settlements are especially likely today, given the intensity of the current price inflation and the historically large declines in real income for the American work force.

Workers today want, and expect, wage increases that considerably outpace the growth in national productivity. Since we have not undertaken a major national program to upgrade productivity, the result is a built in inflationary cost-push bias. The desire on the part of workers for more income is true not only of the union workers but also of non-union employees in both the public and private sectors. Furthermore, many of our retirement programs now include partial or full cost of living escalators. Take, for example, the Civil Service plan. That plan has for some time included a full cost of living escalator and a similar notion has been added to social security benefits recently. Consequently, it would appear obvious that somewhat similar provisions will find their way into private and State and local pension plans in the years ahead.

Note that over 5.1 million workers are covered by collective bargaining contracts which include cost of living escalator clauses -- a mechanism which automatically assures the price-wage inflation that I have been describing. These escalators have an indirect effect also in that they may serve as a pattern for other wage settlements.

While the Government's primary weapons in this inflation battle are restrictive monetary and fiscal policies, these tools affect aggregate demand and have no immediate direct effect on wage costs. It is only if aggregate demand softens for a long period that monetary and fiscal policies will finally affect the price and wage spiral by making it increasingly difficult for businesses to agree to and then pass on higher wage costs in the form of higher prices. I doubt that it is possible to permit the reduction of demand necessary to bring about an adequate cure for this current virulent inflation.

Recent experience short of the foregoing, for example the 1970-1971 period, suggests that slackening aggregate demand and inducing labor market relaxation did not reduce the rate of wage gain. Despite an unemployment rate which reached 6 per cent, wages rose.*

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| 1969 | 6.8% |
| 1970 | 7.1% |
| 1971 | 7.0% |

Thus, within practical limits, given political reality, monetary and fiscal policies are unlikely to be able to do all of the job that is needed. But an appropriate limitation on monetary growth is a <u>necessary</u> but not sufficient condition to the inflation cure.

The Key
<u>Problem</u>

The American people are now accustomed to -- and demand -- annual wage increases that average well in excess of productivity gains. A non-inflationary wage policy calls for wage increases falling in the range of productivity gain.

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* Percentage change in average hourly compensation, private nonfarm economy, seasonally adjusted at annual rates.

Managements quite often feel helpless to resist persistent demands for wage increases far exceeding productivity gains. It is all too easy to raise prices and pass the increased costs along.

While some moderation in wage and price behavior can be achieved through 'jawboning' or appeals to patriotism, the real solution lies in redressing the balance of power in the collective bargaining process and vigorous application of the antitrust and other laws to break up the concentrations of price and wage setting corporate and labor power in our society.

None of the foregoing should be construed as criticism of organized labor. By and large our industrial unions are led by reasonable men acting in the interests of the working people who chose them, and fully using lawful powers. We need, however, to change those laws or the inflation will continue into the years and decades ahead.

The chances of achieving this legislative reform do not appear great at this juncture, for the American people do not understand the problem. Most of our people believe that today's inadequate profits are exorbitant and can 'absorb' continuous rapid wage gains. To most, it is a matter of getting a bigger piece of an existing pie when the real challenge is to improve our productivity and create a larger and ever larger pie, or to learn to live with less.

The current inflation will continue: it is moving into a new phase where those people with economic power -- workers, managers and owners of capital -- are attempting at least to maintain their real incomes in the face of declining real output. Unfortunately, monetary policy can do little about an income-cost-push inflation without risking severe sectoral imbalances and unacceptable unemployment levels, bankruptcies and the like.

Responsible monetary policy is an important element in solving our inflation problem. But we need responsible action across the board. We can enforce vigorously antitrust legislation. We could extend antitrust prohibition to industry-wide unions. We should reexamine regulatory procedures and eliminate all inflationary biases arising from them. We should encourage foreign trade because the competitive pressures from imports encourage responsible wage and price behavior at home.

In addition, I suggest that a most sensible policy in the present circumstance would be a determined national effort to increase productivity. I know that this is a difficult problem, but it is not impossible and the rewards are great. Improving productivity has received inadequate attention in the inflation debate, so I would like to close with a few thoughts on it.

I suggest that an important precondition to increasing productivity in the American economy is to stop thinking of labor as a commodity. To me, labor is more than just a 'factor of production'. In our system, managers make studied decisions to add machinery and accept the concomitant depreciation charges. The decision once made, that 'cost' continues through economic expansion and recession. But, labor costs can be reduced as production falls by laying off workers, and we are currently witnessing another round of this as production slows. We must design and adopt policies which would encourage labor and management to work together on the problem of improving productivity. I suggest that we must move labor to the other side -- the capital side -- of the equation -- that the work force be given an explicit stake in the productive success of the enterprise.

Perhaps an example can best illustrate my position. The Manufacturing Division of Parker Pen Company is located in Janesville, Wisconsin. In the 1960s, this firm was beset by a series of problems which in retrospect look like a microcosm of today's economy-wide difficulties: high labor costs, low productivity, truculent unions and unit costs rising so rapidly that it just did not pay to produce pens in Janesville -- about one-half of the company's production was being subcontracted out. Today, the firm has experienced a turnaround so complete that we can only hope that the national economy can follow suit: through union-encouraged automation, productivity is high, operating costs are low and, since over 80 per cent of the product is now produced in the more efficient Janesville operation, employment is high.

Both labor and management agree that the startling turnabout resulted from a conscious effort to move labor to the other side of the equation. The Parker plan had two parts: (1) a simple formula to distribute a portion of all productivity gains proportionally among the employees; and (2) a system of worker-management committees which collect and process suggestions for improving productivity.

The specifics of the plan can be changed, of course, but the evidence is impressive that significant productivity gains result from giving workers an explicit stake in the progress of the enterprise. Companies should be encouraged to take such initiatives. Indeed, I believe that it would be within the wise application of the Government's fiscal power to offer tax credits to those firms adopting such an approach.

Solutions for the present inflation crisis in our country can only be derived if the nature of the problem is understood by the American people. I am convinced that when they perceive the reality -- that Government action through appropriate monetary and fiscal policies are necessary but not sufficient conditions, they will move through the Congress to create the sufficient condition -- free and flexible markets.