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HONEST MONEY

Remarks by

Henry C. Wallich
Member, Board of Governors of the Federal Reserve System

at the

M.B.A. Graduation Exercises

of the

Fordham Graduate School of Business

New York City

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As you prepare to arise from this seat of learning, the years of intake end, and the moment of output is at hand. You may well suspect that you will never know so much as you do now. For a while, you may feel like those great minds who forget more in a year than some learn in a lifetime. Education, after all, is what remains when all the detail has been forgotten. And if you find yourselves close to some leader of business or government, you may be contributing to great achievement. Nothing is impossible to the man with a competent assistant.

At this time, you are presumably looking at your future role in the world in the broadest possible sense, including a moral sense. Today I would like to talk to you about one aspect of your future that has a moral dimension, although it is technically an economic problem. I mean the breakdown in our standards of measuring economic values, as a consequence of inflation. Nothing that is stated about dollars and cents any longer means what it says. Inflation is like a country where nobody speaks the truth. Our failure to deal effectively with inflation results largely from our failure to regard it as a moral issue.

Inflation as Deceit

Inflation introduces an element of deceit into most of our economic dealings. Everybody makes contracts knowing perfectly well that they will not be kept in terms of constant values. Everybody expects the value of the dollar to change over the period of a contract. But any specific allowance made for inflation in such a contract is bound to be a speculation. We do not know whether the most valuable part of the contract may not turn out to be the paper it is written on. This condition is hard to reconcile with simple honesty.

If our contracts were made in terms of unpredictably shifting measures of weight, time, or space, as we buy food, sell our labor, or acquire real estate, we would probably regard that as cheating, and as intolerable. Yet the case is much the same when we are dealing with monetary values.

Nor are we dealing with small differences between promise and performance. At the going rate of inflation of about 8 per cent, a year at a leading college that today costs $7,000 will cost $32,630 by the time your children approach college age. If you buy an average home, by the time your present life expectancy ends, your heirs could sell it for almost $2.5 million. Of course, the only sure thing about these calculations is that they will not materialize. Inflation is not stable, nor is it predictable. But I hope the illustrations make their point.

The moral issues posed by inflation go beyond what I consider deceit. Inflation is a means by which the strong can more effectively exploit the weak. The strategically positioned and well organized will gain at the expense of the unorganized and the aged. Because inflation is unpredictable, its effects also cannot be predicted and safeguarded against.

Inflation is a means by which debtors exploit creditors. The interest rate may contain an inflation premium, but when you consider that it is taxable to the creditor and tax deductible to the debtor, the scales obviously are ill-balanced. The small saver, moreover, by law is not even allowed to obtain an adequate inflation premium. Interest rate ceilings on savings deposits see to it that he will be a sufferer from inflation. The unpredictability of inflation, again, makes any inflation premium a speculation.

In the eyes of economists and of government, inflation becomes a means of exploiting labor's "money illusion," i.e., its supposed failure to anticipate inflation correctly. The device through which this mechanism operates is the well known "Phillips Curve," i.e., the alleged tradeoff between unemployment and inflation. It is believed that labor will respond to a seemingly large wage offer that subsequently is eroded by inflation. If labor fails to notice the trick, it will keep working for less than it really had demanded, and employment will be higher. A government pretending to serve a nation's interest by, say, misinforming the people about its military plans would be harshly taken to task. Why should trading on the people's money illusion be regarded any differently?

As it happens, the attempt to trade on money illusion has backfired because labor turned out not to be money blind. Mounting inflation was increasingly perceived and as it came to be perceived, to accelerate. In consequence, we got both high inflation and high unemployment. Deceit revealed and rejected nevertheless remains deceit.

Business accounting is made deceptive by inflation. Inventory profits, and profits due to a depreciation schedule that does not take adequate account of replacement costs grossly exaggerate true earnings. The government permits a remedy for the former -- through LIFO -- but not for the latter. The effects on profits of a firm's net debtor or creditor position are ignored. Taxes and dividends are paid from profits that may not exist or, if they can be shown to exist by appropriate accounting adjustments, are not backed up by cash flows. In addition to misleading the stockholder and the public, these conditions push firms into higher leveraging. Business thus becomes more speculative.

Meanwhile, planning ahead becomes more difficult for business. Investment lags, because long-term commitments involve risks that inflation makes incalculable. The need to guard against these unknowable risks compels both parties to any transaction, buyer and seller, employer and employee, lender and borrower, to introduce a risk premium into his pricing. Each must demand a little more or offer a little less than he would under noninflationary conditions. That reduces the range of possible bargains and the level of economic activity. Fewer jobs, less output in the private sector are the results.

Inflation also undermines the honesty of our public policies. It allows the politician to make promises that cannot be met in real terms, because as the government overspends trying to keep those promises, the value of the benefits it delivers shrinks. A permissive attitude toward inflation, allowing the government to validate its promises by money creation, encourages deceitful promises in politics.

Inflation Threatens the Market System, Property, and Democracy

Finally, inflation becomes a means of promoting changes in our economic, social, and political institutions that circumvents the democratic process. Such changes could be forced upon a reluctant nation because inflation may end up making the existing system unviable. One instance is the diminishing ability of households to provide privately for their future. Personal savings, insurance, pension funds all become inadequate. Money set aside in any of these forms for old age, for sickness, for education could be wiped out by accelerating inflation. One may indeed ask whether it is not an essential attribute of a civilized society to be able to make that kind of provision for the future. But that is not the point I want to stress. Rather, I want to emphasize that the increasing uncertainty in providing privately for the future pushes people seeking security toward the government.

Today, the best hedge against inflation is to be retired from the Federal Government. That guarantees a reliably indexed pension which may outgrow the pay of the job itself. Social security is the next best thing, although at a much lower level. Every other form of pension, even if indexed, is exposed to the risk that the employer, or the private sector as a whole, may not be able to perform. A government pension is riskless, short of a strike at the Bureau of Engraving and Printing.

A similar trend toward bigger government threatens at the level of productive enterprise. Inflation, as I have noted, distorts corporate accounting and cash flows. It creates liquidity and profitability problems. Strong firms become less strong, less strong firms become marginal. Dependence upon and eventually absorption by government may be the ultimate outcome. Countries like Italy and Great Britain are already on their way to this solution.

In the United States we have not yet reached that condition, though the increasing passage of the railroads into government hands is a danger signal. But the role of government nevertheless has expanded as the private sector has retreated before the impact of inflation. Mounting regulation, tax burdens, and other impediments, of course, have also contributed their part.

Not long ago it was taken for granted that at full employment the private sector should be strong enough to produce a surplus in the Federal budget. It was expected, in other words, that the inherent impulses of private consumption and especially investment would generate a level of aggregate demand sufficient to absorb capacity output. Today this has become very doubtful. Capital formation is too weak, consumption too low, to generate enough demand to sustain the economy at full employment without the crutches of a Federal deficit.

We might be able to change this by appropriate tax reform that would stimulate investment. We could adopt policies that would cut down our enormous trade deficit that is sucking purchasing power out of the country. But inflation is an obstacle on either of these courses. Tax reform is unlikely to call forth large-scale business investment so long as inflation beclouds the outlook. Policies to improve the trade balance will avail little if inflation reduces our competitiveness.

Thus, by one route or another, inflation creates a vacuum in the private sector into which the government moves. By making the performance of the economy inadequate, inflation is likely to induce expanded government activity. The same result may follow if inflation leads to the imposition of wage and price controls. Indeed, if enduring controls were imposed, which I do not expect, our market economy would be on the way out. Of the three great dimensions of our society -- private rather than public ownership, decision making by the market rather than by central planning, and democracy rather than authoritariamism -- private ownership and market decision making will then be in retreat. No one can say how long, under such conditions, a shift also in the third dimension, away from democracy and toward authoritariamism, can be avoided.

The Sources of Inflation

What can be done? Before we look for remedies, we must examine the causes. Inflation is like cancer -- many substances are carcinogenic, and many activities generate inflation. The sources of inflation can be diagnosed at several levels. The familiar debate about the sources of violence provides an analogy -- do guns kill people? Do people kill people? Does society kill people? Some assert that money, and nothing but money, causes inflation -- the "guns kill people" proposition. Some assert that the entire gamut of government policies -- from deficit spending to protectionism to minimum wage to farm price supports to environmental and safety regulations -- causes inflation -- the "people kill people" proposition. Some argue, finally, that it is social pressures, competition for the national product, a revolution of aspirations, which is at the root -- the "society kills people" proposition. The first view holds primarily responsible for inflation the central bank, the second the government in general, the third the people that elect and instruct the government.

In addition, time preference, the social discount rate, enters into the equation. Inflation usually is the final link in a chain of well meant actions. The benefits of a tax cut, of increased public spending are felt within a few weeks or quarters. The penalty in terms of inflation, may not come until after a couple of years or even later. Inflation is the long-run consequence of short-run expediencies. Life, to be sure, is a succession of short runs, but every moment is also the long run of some short-run expediency of long ago. We are now experiencing the long-run consequences of the short-run policies of the past. These consequences are as unacceptable as rain on weekends, and just as easy to change. If we continue to meet current problems with new short-run devices, the bill will keep mounting.

We will not defeat inflation if we always take the short view. We will then always find that the cost of fighting inflation is always too high, the short-run loss of output and employment too great. We shall find ourselves ignoring inflation, in the hope that it will somehow not grow worse. That is pure self-deception. Cancer ignored does not become stationary, and neither does inflation. Inflation ignored accelerates.

A Plan for Action

A long view is needed on inflation. It is a view very different from that of the politician, who is under enormous pressure to do quickly something that looks good. Harold Wilson said that in politics one week was a long time. More charitably, the pressure is until the next election. If the people will not instruct their elected representatives to do the things that are needed to end inflation, if they turn them out of office because the remedies take time and are temporarily painful, we will keep getting a little more employment and output now at the expense of much more unemployment and loss of output later. And we will get more inflation all along the way, down to its ultimate consequences.

We need to make the ending of inflation our first priority. That must be our overall policy. In the current circumstances, to implement it, we need to take a number of steps, some of which I shall list here.

(1) We need to recognize that we are currently very close to full employment and accordingly must slow down the growth of the economy, gradually but firmly, to its long-term rate of 3-1/4 - 3 1/2 per cent.

(2) We must limit the pending tax cut to what is needed to offset the effect of inflation on income brackets, perhaps of the order of $10 billion.

(3) We must work to bring the budget deficit for 1980 below $40 billion.

(4) Monetary policy must prevent increases in money growth that would fuel inflation and must gradually bring the growth of the monetary aggregates down to levels commensurate with the real growth rate of the economy.

(5) We must stop adding to inflation by government actions such as protectionism, regulation, farm price supports, minimum wage increases, and high government construction costs.

(6) We must promote competition, through anti-trust action, and productivity through tax changes that stimulate investment.

(7) We must maintain as strong a dollar internationally as our balance of payments will permit.

(8) We would be wise to adopt an incomes policy that employs the tax system and the market mechanism, free from the taint of wage and price controls, commonly referred to as TIP.

The President's program of voluntary de-escalation of price and wage increases deserves everybody's support. But in our highly competitive environment, voluntary sacrifices on the part of labor and business have their limitations. We should view the program as a supplement to, not a substitute for, a comprehensive anti-inflation program.

If inflation is a moral problem, we require a moral solution; that is, a recognition that public policies have led to serious inequities affecting people in different and unequal ways and a commitment to new policies that will correct the cumulative distortions and contribute to desired economic progress. The policies I have proposed require taking a long-run view of inflation. Nothing will stop inflation overnight, and in the short run the gains will always seem dearly won. But without such a long-run approach, the damage will mount and the ultimate costs will escalate.

You, as you assume your roles in the productive sector of our nation, are in a better position than anyone to take such a long-run view. You have nothing to gain from the expedients of the past. You have a lifetime interest in the honest, non-inflationary, productive performance of the American economy.

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